TAX TREATMENT OF IMPUTED INTEREST ON DEFERRED PAYMENT SALES OF PROPERTY

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BEFORE THE

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HOUSE OF REPRESENTATIVES

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TAX TREATMENT OF IMPUTED INTEREST ON DEFERRED PAYMENT SALES OF PROPERTY

WEDNESDAY, APRIL 24, 1985

House of Representatives,
Committee on Ways and Means,
Washington, DC.

The committee met at 9:39 a.m., in room 1100, Longworth House Office Building, Hon. Dan Rostenkowski (chairman of the committee) presiding.

Chairman Rostenkowski. The committee will come to order.

Good morning. The Committee on Ways and Means is holding a hearing today on the issue of interest imputed on deferred payment sales of property.

The complexity of these provisions has generated considerable controversy. For that reason, Congress enacted temporary relief legislation last October for a 6-month period to alleviate confusion surrounding the technical provisions. I promised then that the House, and in particular the Committee on Ways and Means, would look thoroughly into the issue and analyze the new rules. This hearing is a part of that process.

Imputed interest rules have been part of the Tax Code for over 20 years. They were enacted in 1964 because Congress recognized that significant tax benefits could be achieved by structuring self-financing to include a low rate of interest. High commercial interest rates in the 1980's focused considerable attention on this area. Tax shelters were able to take advantage of these high rates by structuring their own below-market seller transactions. As a result of understated interest rates, the true purchase price of the property was overstated. The seller benefited from an overstated purchase price because interest income, taxable as ordinary income, was converted into preferred capital gains income. The buyer also received higher depreciation deductions. The Deficit Reduction Act of 1984 sought to remedy some of these abuses.

The committee is aware of the controversy and confusion surrounding these provisions. It is hopeful that some simplification can be achieved in this area without sacrificing the principles in the 1984 act. I hope some of our witnesses will offer constructive suggestions today for reaching a permanent solution that provides simplicity and clarity, but preserves the critical tax policy underlying this issue.

Finally, I remain deeply concerned about the budget deficit. I want to reiterate that budgetary concerns are an important aspect of our consideration today.

At this point, I would like to ask unanimous consent to include in the record the committee's press release announcing this hearing.

Without objection, it is so ordered.

[The press release announcing the hearing follows:]

[For immediate release, Monday, March 25, 1985]

HON. DAN ROSTENKOWSKI (D., ILL.), CHAIRMAN, COMMITTEE ON WAYS AND MEANS, U.S. HOUSE OF REPRESENTATIVES, ANNOUNCES A HEARING ON THE TAX TREATMENT OF IMPUTED INTEREST ON DEFERRED PAYMENT SALES OF PROPERTY

The Honorable Dan Rostenkowski (D., Ill.), Chairman of the Committee on Ways and Means, U.S. House of Representatives, today announced a hearing on the Federal tax treatment of imputed interest on deferred payment sales of property on Wednesday, April 24, 1985, beginning at 9:30 a.m. in the Main Committee hearing room, 1100 Longworth House Office Building. The hearing will focus on the changes to the imputed interest rules of the Internal Revenue Code made by the Deficit Reduction Act of 1984 (P.L. 98-369) and by the subsequent stopgap legislation (P.L. 98-612).

In announcing this hearing, Chairman Rostenkowski said, "There has been much confusion and controversy surrounding the imputed interest provisions since their enactment last year. Last fall when Congress passed temporary legislation modifying the new rules, I promised that the Committee on Ways and Means would conduct a comprehensive analysis of the subject. This hearing is an important part of that analysis. I expect this hearing to help put the issue of imputed interest and the effect on deferred payment transactions involving seller financing in proper perspective. It is my hope and expectation that permanent, revised imputed interest rules will be enacted prior to the expiration of the stopgap provisions on July 1. However, I also want to emphasize that the budgetary consequences of any such revisions will be an important aspect of the Committee's consideration of any revised imputed interest rules."

BACKGROUND

The imputed interest provisions enacted in the 1984 Act were part of a larger legislative effort to restrict abusive tax shelters, to curtail excessive unintended tax benefits, and to reduce Federal deficits. One of the Act's major reforms focused on the "time value of money," which reflects the difference in value between the right to an amount today and the right to the same amount at some future time. The failure of the tax system to deal adequately with the time value of money can allow a taxpayer to postpone current payment of tax through accelerating deductions and deferring income. In the case of seller-financed sales of property, the use of an artificially low rate of interest permits the seller to recharacterize interest income as capital gain and may permit the buyer to overstate the basis of the property for purposes of depreciation and the investment tax credit.

Under prior law, Code section 483 recharacterized payments of principal and interest in certain deferred payment transactions where interest was not stated or the stated interest was below a safe-harbor rate fixed by Treasury regulations, most recently set at nine percent. Although this safe-harbor rate was periodically modified, it lagged behind actual market rates. Section 483 also did not require interest to be computed on an economic (compounded) basis. In addition, although the prior original issue discount (OID) provisions attempted to match the timing of inclusions, and corresponding deductions of interest on debt instruments, these rules did not apply to obligations issued in exchange for property unless either the debt obligation or the property was traded on an established securities exchange.

Deficit Reduction Act of 1984.—The amendments made by the 1984 Act were intended to correct the deficiencies in prior law. They applied the OID rules to many debt-for-property transactions and changed the nine-percent safe harbor rate to 110 percent of the "applicable federal rate," with limited exemptions, beginning January 1, 1985. The applicable Federal rates are set currently to reflect the short, medium, and long term cost of funds to the Federal government. The 1984 Act also required interest to be computed on an economic basis, and required both buyers to accrue interest expenses and sellers to accrue interest income annually.

Stopgap legislation.—In response to the controversy over these new imputed interest rules, Congress passed stopgap legislation (P.L. 98-612) to provide a lower imputed interest rate on certain transactions occurring before July 1, 1985. Under that legislation, seller-financed transactions involving loans of $2 million or less are subject to a test rate of nine-percent compounded semi-annually. Transactions involving loans over $2 million use a "blended" rate of nine percent on the first $2 million of borrowings and 110 percent of the applicable Federal rate on borrowings over $2 million.

SCOPE OF HEARING

The Committee invites testimony both on the provisions enacted in the Deficit Reduction Act of 1984 and the stopgap legislation which is due to expire on July 1, 1985. To the extent that revisions are advocated, the Committee encourages witnesses to provide constructive alternatives to last year's provisions.

DETAILS FOR SUBMISSION OF REQUESTS TO BE HEARD

Requests to be heard must be made by telephone to Harriett Lawler [telephone (202) 225-3627] by the close of business, Friday, April 12, 1985. The oral request should be followed by a formal written request no later than Tuesday, April 16, 1985, addressed to Joseph K. Dowley, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515.

Those persons and organizations not scheduled for an oral appearance will be encouraged to submit written statements for the record of the hearing. All persons requesting to be heard, whether they are scheduled for oral testimony or not, will be notified as soon as possible after the filing deadline.

It is urged that persons and organizations having a common position make every effort to designate one spokesman to represent them in order for the Committee to hear as many points of view as possible. Time for oral presentations will be strictly limited with the understanding that a more detailed statement may be included in the printed record of the hearing. This process will afford more time for Members to question witnesses. In addition, witnesses may be grouped as panelists with strict time limitations for each panelist.

In order to assure the most productive use of the limited amount of time available for questioning witnesses, witnesses appearing before the Committee are required to submit 200 copies of their prepared statements to the full Committee office, 1102 Longworth House Office Building, at least 24 hours in advance of their scheduled appearances.

Requests to be heard, prepared statements to be presented in person, and statements filed for the printed record of the hearing, must contain the following information:

(1) The name, full address, and capacity in which the witness will appear, as well as a telephone number where the witness or a designated representative may be reached; (2) a list of any clients or persons, or any organization for whom the witness appears; and (3) a topical outline or summary of comments and recommendations.

WRITTEN STATEMENTS IN LIEU OF PERSONAL APPEARANCE

Persons submitting written statements for the printed record of the hearing should submit at least six (6) copies by the close of business, Friday, April 19, 1985, to Joseph K. Dowley, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. (See other requirements enumerated above.) If those filing written statements for the record of the printed hearing wish to have their statements distributed to the press and the interested public, they may provide 100 additional copies for this purpose to the Committee office before the hearing begins.

Chairman ROSTENKOWSKI. I want to call on the ranking minority member, Mr. John Duncan, for a statement.

Mr. DUNCAN. Thank you, Mr. Chairman.

I commend you for calling a hearing on this important subject. The enactment of the imputed interest provisions of the 1984 Deficit Reduction Act created a certain amount of controversy, and you wisely led the way in enacting a stopgap provision to postpone several aspects of those provisions. But those stopgap provisions are expiring June 30 of this year, and it is most appropriate that we are taking testimony relevant to what pertinent changes should be made.

I believe that we should be careful not to impose undue burdens on taxpayers, and particularly those involved in relatively small transactions. At the same time, I think we have to be careful. The testimony that we receive today should be very helpful to all of us in developing appropriate measures.

With that in mind, Mr. Chairman, I look forward to hearing from our witnesses.

Chairman ROSTENKOWSKI. Thank you, Mr. Duncan.

Our first witness is the Honorable John Melcher, a former Member of the House of Representatives in better days.

Mr. Melcher, if you would like to assume the witness stand and present your testimony, the committee is ready to proceed.

STATEMENT OF HON. JOHN MELCHER, A U.S. SENATOR FROM THE STATE OF MONTANA

Senator MELCHER. Thank you very much, Mr. Chairman.

I do come back here this morning with a certain amount of reverence and nostalgia, but I think most of all respect for the institution of the House and the functions that the House carries out in the business of the Senate and the rest of the country. And I say that rather humbly, Mr. Chairman.

This question of imputed interest rates is an old argument. It is one that I have had an interest in since 1979. It is one I hope we will see resolved satisfactorily during the timeframe that we have between now and July 1. I trust that that can be done.

I am just going to touch on a couple of points of the legislation that I have introduced to the Senate, and then ask unanimous consent that my complete testimony may be made part of the record.

Chairman ROSTENKOWSKI. Without objection, your entire testimony will be included in the record.

Senator MELCHER. We will be dealing with two tiers in this legislation, and I say right from the outset I do not believe that the amount, the specific amounts that have been brought up in the numerous bills is the real question. I think the point is that there are different tiers identified there and I can live within the range that has been discussed in the past couple of months and legislation that has been introduced. Whether it is $2 million for the first tier or $3 million, or $2½, or $4 million, I do not think that is the point so much as it is—I think sellers should be permitted to blend interest rates permitted for amounts under the first year so that in effect the tax rate would never reach 80 percent of the Treasury rate, nor would the imputed rates ever reach 100 percent of the Treasury rate.

I believe language to ensure sales involving loan assumptions should be clear that it would permit the transaction to be considered as if it occurred before the 1984 Tax Act and, finally, the bill, I believe, should repeal sections of the 1984 Tax Act that took away from the purchaser's right to deduct the full amount of any imputed interest that is deemed to have been paid to himself prior to the Before Tax Act, I understand it, is how it was imputed for the rate higher than the rate written into the tax rate equal to the imputed rate.

I believe also that the simple two-tiered system for imputed interest rates suggested by you, Mr. Chairman, in the temporary provision last fall make sense, and I believe the legislation we finally enact this year, that should form the basis of the final act.

And finally, Mr. Chairman, what is more important at this time is that we start moving quickly to get a permanent solution. And as I interpret your opening remarks, that is your determination and the determination of this committee. And as a former House Member, I well recall the declarations of the chairman of the Ways and Means Committee were carried out and his timeframes were met. And I am very grateful for that and trust that that will be the case in this matter.

I feel that we are very close together in the concept of what we want in the legislation. And also I am well aware that on any votes we have on this previously in the Senate look like within that confine of what we are talking about, we got about 75 percent of the votes over there, perhaps 100 percent.

[The prepared statement follows:]

STATEMENT OF HON. JOHN MELCHER, A U.S. SENATOR FROM THE STATE OF MONTANA

Mr. Chairman, I am very pleased that these hearings are being held this morning. July 1 is approaching quickly and unless Congress enacts permanent legislation prior to that date correcting what I believe to be serious problems with our tax policy on imputed interest rates, we will see a drastic unneeded decline in seller-financed transactions of real estate.

My interest in the imputed interest rate issue goes back to 1979 when the Internal Revenue Service proposed to issue new regulations increasing imputed interest rates from 6 percent to 9 percent. I joined in the public comment on these proposed regulations, opposing the increase. In spite of the fact that there were some 2,500 responses to this imputed interest rate increase, all of which were in opposition, the IRS went ahead with the regulatory increase.

During consideration of the 1981 Tax Act, I challenged the IRS action, and the Senate by a vote of 100 to 0 passed my amendment exempting the first $1 million of any transaction from the higher rate. Unfortunately, in the final version of the Act my proposal was watered down to exempt only the first $500,000 of seller-financed transactions between related individuals.

The 1984 Tax Act went much further in increasing imputed interest rates. As you well know, it created a formula for calculating imputed interest rates. It mandated that if the interest rate stated in a seller-financed contract was not at least 110 percent of applicable federal rates, then that seller would be taxed as if the interest rate had been 120 percent of the applicable federal rate.

Had this new law gone into effect on January 1, 1985, it would have mandated interest rates of up to 14 percent in seller-financed contracts. I was convinced that this would have effectively eliminated the option of seller-financed transactions at a time when high commercial interest rates were already killing the real estate market. On June 29, 1984 I offered an amendment to the Technical Corrections Resolution accompanying the Tax Act to provide some limited relief for farmers and ranchers, small business people, and homeowners. Although my amendment was tabled, a small step was taken to exempt some transactions from the new higher rates.

Subsequently, I and several other members of Congress offered legislation to either modify or repeal the imputed interest rate portions of the 1984 Tax Act before they were to go into effect on January 1. However, as the final days of Congress were slipping by last October, the Senate still had not taken action to correct the problem.

At that time, there were two approaches available to us for corrective action. One would have repealed the 1984 provisions, leaving everyone where they were prior to enactment of that tax bill. This approach had the simplicity of leaving imputed interest law the same as it has been for the past three years.

The second approach was to pass amendments that were easily understood and workable, leaving assumable loans alone by not causing them to be renegotiated and imputed interest applied, and exempting the first $2 million of any seller-financed sales of homes, land and small business property. That is about what Congress finally agreed upon, but just until July 1 of this year when we must have a permanent law adopted.

Unless we change the 1984 tax law by July 1 there will be very few seller-financed property sales. That means that any estimate of revenue gained by the new 1984 Tax Act provisions on imputed interest rates likely would be greatly overestimated by the Treasury Department because it blithely assumes that the same historic level of seller-financed property sales will continue. That would not be the case under the 1984 law because it will be a very rare person indeed who will find it sensible to sell property on a contract that will make the seller liable for income tax based on imputed interest income that the seller has never received.

Sellers simply will not be able to finance sales on that kind of a basis. Buyers will have to find other types of financing that will doubtlessly result in higher interest, and if the buyers cannot afford to pay the higher interest, the sale just will not be made.

As surely as night follows day. The Treasury Department estimate of a revenue loss of $2.2 billion if the provision were repealed is a false estimate, more worthy of fiction than fact.

I have introduced legislation, S. 217, that corrects the imputed interest rate problems created by the 1984 Tax Act by providing for a simple two-tier approach to imputed interest rates similar to the one taken by the House of Representatives in temporary legislation passed last October.

The first tier applies to debt amounts up to $2 million. In these smaller property sales, the bill permits the seller to set the interest payments at 9 percent, which was the interest rate permitted prior to passage of the 1984 Tax Act. The bill also permits interest rates of less than 9 percent to be written into the contract should commercial interest rates drop substantially from current levels. An interest rate equal to 80 percent of Treasury rates may be used if that would result in a rate less than 9 percent.

If these requirements are not met in seller-financed property sales with debts of less than $2 million, then the Treasury is authorized to impute an interest rate to the seller-financer of 10 percent, or 100 percent of applicable Federal Treasury rates, whichever is lower.

The second tier deals with debt amounts above $2 million. For loan amounts exceeding $2 million the seller is permitted to write an interest rate equal to 80 percent of Treasury rates into the contract. If that requirement is not met, then the Treasury Department is authorized to impute an interest rate to the seller equal to 100 percent of Federal rates.

Further, sellers are permitted to blend interest rates permitted for amounts under $2 million with the interest rates required for amounts over $2 million, so that in fact the test rate would never actually reach 80 percent of Treasury rates, nor would the imputed rate ever reach 100 percent of Treasury rates.

The bill contains language to insure that sales involving loan assumption are left as they were before the 1984 Tax Act. There was no specific language in the 1984 Tax Act on loan assumptions, but there was some language in the Conference report which alluded to seller financing where loan assumptions were involved. The Treasury Department has stated that it believes that this is sufficient to give it authority to require that in deals where there is a loan assumption, the interest rates on the assumed loan must be increased to meet the new imputed interest rates in the 1984 Tax Act. This bill makes it clear that the new imputed interest rates are not to apply to existing loan assumptions.

Finally, the bill repeals a section of the 1984 Tax Act that took away the purchaser's right to deduct the full amount of any imputed interest that is deemed to have been paid to the seller. Prior to the 1984 Tax Act, if the seller were imputed an interest rate for tax purposes higher than the rate written into the contract, then the purchaser was permitted to take tax deductions for interest payments associated with the contract equal to the imputed rate. However, with the passage of the 1984 Act, purchasers were limited to deducting the amount of interest stated in the contract, no matter what higher interest rate was deemed to be income to the seller—thus setting up an imbalance between the tax treatment of the seller and purchaser. I don't believe this is right, and this bill will restore tax neutrality to seller-financed transactions.

I believe that the simple two-tier system for imputed interest rates suggested by the Chairman in the temporary provisions last fall makes sense. I have made that the basis of my bill.

Senator Durenberger has introduced similar legislation that permits a $4 million exemption for the first tier of transactions. I find that fully acceptable and will support it. The real key to solving the imputed interest rate problem is not the specific size of the exemption, but establishing a test rate that is fair. That means a test rate that protects against abusive transactions, but a test rate that still permits legitimate seller-financed transactions to occur. I do not believe that the test rate has to be as high as commercial interest rates. It only has high enough to eliminate truly abusive transactions. I believe that the 80 percent test rate accomplishes that.

Finally, Mr. Chairman, what is most important at this time is that we start moving quickly to get a permanent solution to the imputed interest rate problem. As I said, July 1 is quickly approaching. I hope that we can move from this hearing to action in the Committee and in the full House. I intend to urge the Finance Committee to follow your example and call hearings in imputed interest rates in the very near future.

I applaud your initiative in moving on this issue so that we can get a permanent solution to a serious problem.

Chairman ROSTENKOWSKI. Thank you, Senator, for sharing your views with us.

Are there any questions?

[No response.]

Chairman ROSTENKOWSKI. Thank you, Mr. Melcher.

The Chair calls the Assistant Treasury Secretary for Tax Policy, Ron Pearlman. Mr. Pearlman, welcome to the committee. It is always a pleasure to have you share your views with us.

If you are ready to proceed, please do so.

STATEMENT OF HON. RONALD A. PEARLMAN, ASSISTANT SECRETARY FOR TAX POLICY, DEPARTMENT OF THE TREASURY

Mr. PEARLMAN. Mr. Chairman and members of the committee, I am pleased to present the views of the Treasury Department on the application of the imputed interest and original issue discount, OID, rules to seller-financed sales of property. We are pleased to participate in the committee's reexamination of these provisions in light of the expiration at the end of June of temporary rules contained in Public Law 98-612.

The Tax Reform Act of 1984—the 1984 act—refined the imputed interest rules of prior law to require that taxpayers, one, determine whether adequate interest is stated in a contract for the sale of property by testing against interest rates which more closely approximate market interest rates and, two, allocate interest, including imputed interest, to the periods to which it relates and take the interest into account for that period. Taken together, these changes provide for the proper economic treatment of deferred payment obligations arising in connection with the sale or exchange of property. The new rules will largely prevent the abuses which arose prior to the 1984 act, including mismatching of income and deduction, overstatement of tax basis and investment tax credit, ITC, and accelerated cost recovery system, ACRS, allowances and the conversion of ordinary income into capital gain taxed on a deferred basis.

Although the Treasury Department believes the 1984 act rules provide the proper tax treatment for sales and exchanges of property, we support efforts to provide simpler rules for small transactions. In view of the expiration of the temporary rules contained in Public Law 98-612, I will discuss the application of the imputed interest and OID rules to transactions involving relatively small amounts. I will then address certain improvements that we believe can be made in these rules for larger transactions. Finally, I will comment on the rules relating to transactions where an existing debt obligation is assumed or property is taken subject to an obligation.

BACKGROUND

Congress substantially modified the imputed interest and OID rules in the 1984 act. As this committee considers the appropriate permanent rules for seller-financed sales of property, it is important to review both the prior law rules and the reasons for the 1984 act amendments.

Beginning in 1969, holders of publicly traded discount obligations or obligations issued for publicly traded property were required to include and issuers were able to deduct OID over the term of the obligation, without regard to whether the parties were on the cash or accrual method for other items of income and deduction. This treatment of original issue discount is based on two premises. First, the rules recognize that original issue discount represents interest that will accrue, but not be paid currently during the term of the obligation; this deferral is the economic equivalent of the borrower paying the interest which accrues currently with additional funds borrowed from the lender. Second, the requirement that the issuer and holder of an original issue discount obligation report original discount on the accrual method ensures consistent accounting. Without such a rule, the parties could mismatch income and deductions.

The prior law OID rules, however, did not apply to obligations issued by individuals or to obligations issued in exchange for nonpublicly traded property. Thus, transactions involving the purchase of real estate or nonpublicly traded personal property in which there was seller financing were outside the scope of the original issue discount rules even if the financing permitted interest to accrue without being paid currently.

Deferred payment obligations issued in exchange for nonpublicly traded property, including obligations issued by individuals, however, were subject to section 483. Section 483 required the parties to state a minimum rate of interest—under prior law, 9 percent simple interest—or interest would be inputed at a higher rate—10 percent compounded semiannually. Section 483 provided a maximum test rate of 7 percent for related party real estate transactions involving $500,000 or less.

REASONS FOR CHANGE

Limited scope of OID rules: Under prior law, the OID rules did not apply to deferred interest obligations issued in connection with the purchase of real estate or nonpublicly traded personal property—such as machinery—or to such obligations issued by individuals. In these situations, tax avoidance opportunities resulted from the fact that interest would accrue each year, but would not be paid until maturity. The issuer of the obligation, if using the accrual method of accounting, could claim annual interest deductions while cash method holders deferred inclusion of the discount until maturity.

The ability to mismatch income and deductions for OID formed the basis for numerous real estate and other tax shelter offerings. The revenue loss from these tax shelter offerings was significant and increasing dramatically as this structuring technique became known and used widely in transactions involving seller-financing. An example illustrates the magnitude of the revenue loss from a typical transaction: a $5 million obligation bearing interest at 12.5 percent, compounded annually, and payable in a lump sum after 20 years is exchanged for property. An accrual method obligor in the 50 percent tax bracket would claim interest deductions over the term of the obligation having a present value of $5.6 million. Because the cash method obligee would defer recognition of interest income until maturity, the present value of the tax paid by the obligee in the 50 percent tax bracket is $2.3 million. Thus, the revenue loss from one $5 million transaction from the mismatching of interest income and deduction is approximately $3.3 million on a present value basis. Of course, for larger transactions, the revenue loss would be proportionately larger—for example, $13.1 million for a $20 million transaction.

In addition to the asymmetrical treatment of issuers and holders, discount bonds issued in tax shelter transactions of the type described above frequently embodied a noneconomic computation of interest—that is, simple interest payable on a deferred basis. Reporting interest on a simple interest basis accelerates interest deductions by ignoring the compounding of interest on deferred but unpaid interest; thus, interest is not properly allocated to the period in which it actually accrues. Cash method holders of the obligations are, of course, indifferent to these timing concerns because they defer inclusion until maturity. Although the use of noneconomic interest calculations was largely proscribed by Rev. Rul. 83-84, 1983-1 C.B. 97, we understand that several tax shelter offerings made prior to the 1984 act took positions inconsistent with this ruling.

Deficiencies of section 483. The tax law provides for different treatment of interest and principal of debt obligations given in exchange for property. In addition, other tax consequences flow from the characterization of payments as either interest or principal, such as the seller's amount realized and the buyer's tax basis in the acquired property. Section 483 was originally enacted to ensure that parties properly characterized as interest or principal amounts paid pursuant to obligations given in exchange for property.

Without interest imputation rules such as those provided in section 483, whenever a debt obligation is given in exchange for property, the parties would have the flexibility to adjust the rate of interest charged and the principal amount of the obligation so as to produce an optimal tax result without altering the underlying economic transaction. If these distortions were permitted, a seller could convert ordinary interest income into capital gain, taxable on a deferred basis under the installment sale rules, or gain that might be deferred indefinitely where a residence is sold. In the case of a buyer, the tax basis of the acquired asset would be overstated and excess ACRS allowances and ITC would be claimed.

An overstatement of principal and understatement of interest may also occur, and often does occur, even when the parties are not purposefully attempting to avoid taxes. For example, suppose a taxpayer has a piece of property which he genuinely believes is worth $1 million. He wishes to sell the property at this price but is unable to find a willing buyer. In order to move the property, the taxpayer decides—for nontax reasons—not to lower the purchase price but to offer seller financing at a below-market rate for a portion of the purchase price. This enables the taxpayer to close the sale transaction.

In this situation, the fact that the seller had to offer below-market financing to sell the property indicates that the property was not worth $1 million. Thus, even if tax avoidance was not the goal of either party to the sale, the seller has converted ordinary interest income into capital gain and the buyer has obtained an overstated basis.

This tax advantage is never available where a third-party lender finances the purchase of property, unless the seller makes a payment to the lender to buy down the buyer's interest rate. In such cases, the interest rate for the borrowing and the purchase price for the property are independently fixed at arm's length.

Historically, the section 483 test rates have been adjusted only infrequently, and have often been at rates considerably below market interest rates. To the extent that the test rate provided under section 483 is less than a market rate of interest, the buyer and seller may improperly characterize a portion of deferred payments as principal and understate their tax liability. Thus, a below-market test rate effectively provides a tax subsidy for seller-financed sales of property.

Prior to the 1984 act, we became aware of a substantial, and rapidly increasing, number of transactions that exploited the below-market interest test rate and the noneconomic simple interest computation provided under section 483. In one case brought to our attention, a tax basis of more than five times the established fair market value of the property was claimed. Under a proper economic analysis, the excess basis—that is, the amounts payable under the obligation in excess of the fair market value of the acquired property—represents interest and should be deductible only as it accrues over the life of the obligation. However, by virtue of the defective operation of section 483, taxpayers claimed that the excess was transformed into inflated ITC and ACRS allowances which had a materially higher present value than the interest deductions.

The 1984 act changes: These abuses prompted the Treasury Department to propose a number of changes to section 483 and the OID rules. Congress adopted these proposed changes as part of the 1984 act.

Section 1274: For transactions involving deferred payments for the sale of nonpublicly traded property, the 1984 act establishes safe harbor interest rates based on the term of the obligation to test whether the obligation states adequate interest. If the parties to a sale or exchange of nonpublicly traded property involving deferred payments fail to state adequate interest, interest is imputed at a higher rate. The safe harbor test rate is 110 percent of the "applicable Federal rate" and the rate at which interest is imputed is 120 percent of the applicable Federal rate. The applicable Federal rates, or AFR, are based on average market yields on outstanding Treasury obligations of comparable maturity. The Treasury is to determine the rates for Treasury obligations with maturities of 3 years or less—the Federal short-term rate, over 3 years but less than 9 years—the Federal mid-term rate, over 9 years the Federal long-term rate.

The 1984 act also expands the scope of the OID rules. After December 31, 1984, obligations issued by individuals and obligations issued for nonpublicly traded property which provide for deferred interest or which fail to state adequate interest are subject to the OID rules.

The section 1274 rules embody two concepts: One, a test rate designed to approximate a market rate of interest and, two, OID rules requiring the parties to take into account, on the accrual method, imputed interest, where adequate interest is not stated, or stated interest where adequate interest is stated, but is not paid currently.

In recognition that the new rules impose a greater degree of complexity than the prior law rules, Congress provided several exceptions for routine transactions and transactions not involving large amounts of money. Thus, sales of principal residences, certain sales of farms for less than $1 million, and any sales involving total payments of $250,000 or less are not subject to section 1274.

Changes to section 483: The application of section 483 was limited to deferred payment transactions involving sales or exchanges of property falling within one of the exceptions to the OID rules. The existence of unstated interest is tested with reference to the applicable Federal rates established under the OID rules. Where imputed interest is present, however, it will be taken into account only as payments are made, rather than under an accrual method, as provided in section 1274. Thus, under section 483, principal payments are recharacterized as interest to the extent that imputed interest has accrued but has not been paid through the time of payment.

In cases involving the sale or exchange of a principal residence—to the extent of the first $250,000 of the cost of the residence—or farmland costing less than $1 million, the 1984 act provided that the test rate previously applicable under section 483 would apply. Thus, the existence of unstated interest would be determined by reference to a 9-percent test rate.

Public Law 98–612: After passage of the 1984 act, a number of concerns were raised regarding the impact of the changes described above on relatively small transactions. To address some of these concerns temporarily and permit the Congress to reexamine the OID and imputed interest rules in this session, Congress passed Public Law 98–612 in October 1984 which contained temporary and permanent rules relating to seller-financed sales of property. Most importantly, Public Law 98–612 provided that, for sales or exchanges of property, other than new section 38 property, occurring prior to July 1, 1985, the test rate is 9 percent, compounded semiannually, on up to the first $2 million of seller financing. For transactions involving more than $2 million of total financing, the test rate is a weighted average of 9 percent and 110 percent of the applicable Federal rate.

Public Law 98-612 also provided that sections 1274 and 483 generally apply to assumptions of existing obligations in connection with sales or exchanges of property or taking property subject to an existing obligation. Congress, however, specifically exempted from the scope of sections 483 and 1274 assumptions of obligations originally issued on or before October 15, 1984, in transactions where the sales price does not exceed $100 million. Public Law 98-612 also provided exemptions from the rule on assumptions generally for transactions involving, one, personal residences; two, property used in the active conduct of the trade or business of farming; and, three, property, other than new section 38 property, used in an active trade or business.

SMALL TRANSACTIONS

Although the principles underlying the OID and imputed interest rules are equally applicable to all seller-financing transactions, we recognize that these rules impose additional burdens in planning sales transactions and that these burdens weigh proportionately more heavily on small transactions. Therefore, we agree it is appropriate to consider rules that would simplify the system for small transactions.

We feel obligated to point out to the committee, however, that any system that provides different rules for small and large transactions must also describe in what circumstances transactions will be aggregated for purposes of ascertaining whether the small transaction rules should apply. Without clearly defined aggregation rules, the large transaction rules could easily be avoided. For example, a seller of a single piece of property worth $5 million cannot be permitted to benefit from the small transaction rules by selling five separate 20-percent interests in the property to the same buyer in five transactions taking place at substantially the same time. While this type of abuse can be dealt with easily enough, other cases involving a single seller and multiple buyers or multiple sellers and a single buyer will present significant problems. While the difficulties of formulating fair and workable aggregation rules are not substantial, we believe that these problems are outweighed by the need to provide simpler rules for small transactions.

FIXED TEST RATE

Prior to the 1984 act, the prevailing test rate was widely known and individuals could structure routine transactions without consulting tax periodicals or a tax professional to determine the current applicable Federal rates. To continue this system for relatively small transactions, we would support the application of a fixed lower test rate. This rate would be adjusted only to reflect significant long-term shifts in market interest rates.

We suggest that the lower rate be fixed initially at 9 percent, based on compounding at least annually. This fixed rate would provide a degree of certainty and simplicity for small transactions by removing the need to refer to the applicable Federal rate, which changes frequently. To give some effect to shifts in market rates, however, this fixed rate might automatically adjust when the applicable Federal rates shift very substantially and remain at the new levels for a relatively long-time period. At the end of this time period, the small transaction rate could be adjusted to, for example, the nearest whole percentage equivalent to 80 percent of the current monthly Federal midterm rate. Of course, if the test rate applicable to large transactions actually fell below the fixed small transaction rate, the parties would be permitted to use the lower test rate.

A fixed rate for small transactions, adjusted infrequently is far preferable to a floating rate, such as a fixed percentage of the applicable Federal rate. Although such a system would always result in a below-market test rate for small transactions, the floating rate would do nothing to eliminate the uncertainty for transactions involving relatively small amounts of money since the parties would still be required to consult current market interest rates simply to structure such transactions.

DEFINITION OF SMALL TRANSACTION

The distinction between large and small transactions can be based on either the purchase price of the property or on the amount of seller financing involved. If the purchase price of the property is the basis for the distinction, we suggest that the special rule for small transactions be limited to transactions with a purchase price of $2 million or less. For this purpose, purchase price would include cash and the fair market value of any property transferred to the seller, as well as the stated principal amount of any financing. Alternatively, if the committee prefers to continue to base the distinction between large and small transactions on the amount of seller financing, we suggest that the special rule for small transactions be limited to transactions where the amount of seller financing, we suggest that the special rule for small transactions be limited to transactions where the amount of seller financing does not exceed $1 million.

For transactions above whichever of these thresholds is chosen, the parties generally are sufficiently sophisticated to be aware of current market interest rates, and we are not persuaded that the additional complexity involved in consulting current applicable Federal rates is burdensome when compared to the other complexities that inevitably accompany a sale of an expensive property. When a below-market interest rate is charged in such large transactions, the parties should be fully aware of the relationship between the purchase price and the interest rate charged, as well as the resulting tax consequences.

APPLICATION OF OID RULES TO SMALL TRANSACTIONS

Some have suggested that parties to a small transaction should have the option to elect cash accounting for both parties in lieu of the OID rules. In evaluating this option, it is important to bear in mind that the OID rules apply only if the parties to a sales transaction do not provide adequate stated interest or if the transaction does not call for interest to be paid currently. Since virtually all taxpayers will provide at least the 9-percent interest required to avoid imputed interest, this option is important only in situations where the parties provide for deferred interest.

We acknowledge that an election to report deferred payments on the cash method may be simpler for the parties than the OID rules. However, the existence of two separate accounting systems for small and large transactions also would create new complexities. For example, assume that property is sold under the small transaction role and the parties elect the cash method; subsequently, the property is resold in a transaction which is subject to the OID rules and the original obligation is assumed. In this situation, may the subsequent purchaser accrue interest deductions currently while the original seller continues to report interest income only as received? Alternatively, assume the seller of the property disposes of the buyer's obligation to an accrual basis taxpayer. Is the subsequent holder entitled to use the seller's cash matching election? Rules that would have to be provided to deal with such problems would make the cash method election potentially very complicated.

A cash-matching election also involves potential for abuse. For example, an owner of property could sell to a tax-exempt intermediary for a note calling for deferred interest payments, with the parties electing the cash method. The tax-exempt intermediary could then sell to the intended buyer on the same terms, with the buyer and the intermediary not electing the cash method. The buyer could then report current interest deductions under the OID rules, while the seller would have no current interest income inclusion. The intermediary would use its tax exemption to insulate itself from adverse consequences of the OID interest inclusions.

Although a rule could be designed to address this particular arrangement, we are not optimistic that every type of transaction which is similar to this arrangement and exploits differences in marginal tax rates could be stopped. If effective antiabuse rules are not developed to address all schemes structured to avoid the requirement that the parties to a deferred payment sale of property account consistently for the interest element in the transaction, one of the major abuses addressed in the 1984 act, the potential for mismatching income and deductions, will remain.

In view of the inevitable complexity involved with separate accounting systems for small and large transactions and the potential for abuse, we would urge the committee not to adopt a special accounting rule for small transactions.

Application of small transaction rules to dealers: We suggest that any special rules for small transactions apply only to casual sales of property. Special rules for small transactions can be justified only on the ground that the generally applicable imputed interest and OID rules are too complex when relatively unsophisticated parties are buying or selling property. Dealers that regularly transact for the sale or purchase of property are sufficiently sophisticated to be aware of current market interest rates. Indeed, many dealers in residential real property are New York Stock Exchange listed firms that engage in thousands of sales annually. These taxpayers have little basis for claiming the new imputed interest and OID rules are overly complex. Moreover, exempting dealers from the small transaction rule would obviate many of the more difficult aggregation issues referred to earlier.

NO SPECIAL RULE FOR SALES OF CERTAIN TYPES OF PROPERTY

A broadly based special rule for small transactions would provide a degree of certainty for parties to routine sale transactions and can be justified on the grounds of simplicity. This rule would apply to sales of all types of property including sales of small businesses, residence and farms. Therefore, we oppose providing additional exceptions to these rules for transactions in these or other special types of property. Such exemptions are unnecessary in light of the small transaction rule and constitute a subsidy for transactions in such types of property. Moreover, each additional exception adds complexity to the Internal Revenue Code and to the regulations as rules must be formulated defining the scope of each exception, identifying and preventing abuses, and regarding the interrelationship of the various exceptions.

If a general exception for small transactions of all types is adopted, the existing special rules that provide lower rates for transactions in certain types of property are no longer needed. Thus, we would support the repeal of the existing special rules for certain types of transactions, including the rules relating to sales of principal residences, sales of farms and sales of land between related parties.

SUGGESTED CHANGES TO THE BASIC RULE

Although we believe that the rules enacted in the 1984 act generally provide for the correct treatment of seller-financed sales of property, we think that a number of improvements can be made in the existing statutory structure. I turn now to these matters.

Selecting the appropriate interest rate index: As I have already stated, if one party sells a piece of property to another in a transaction that calls for one or more deferred payments, and if the deferred payments do not include an interest charge at a market rate of interest, the parties have the opportunity to overstate the purchase price for the property. The question then arises, what constitutes a "market rate of interest"? The current statute answers this question by reference to the rate at which the Federal Government borrows money, taking into account, to a limited extent, the term of the obligation.

We continue to believe that an interest rate index based on the yields on U.S. obligations is the most reliable and appropriate indictor of market rates of interest, for the following reasons:

The Federal borrowing rate accurately reflects trends in the market rate at which a given borrower could obtain funds from an unrelated lender.

A rate based on the yield of U.S. Government obligations is not subject to manipulation.

U.S. Government rates are readily available; no data need be gathered from third party sources.

There is a large volume of U.S. obligations with remaining maturities ranging from 30 days to 30 years. This assures a statistically valid data base from which to compute the market interest rate index.

The imputed interest rules provide that the applicable Federal rate is multiplied by a factor of 110 percent to compute the appropriate test rate. This multiple reflects that even the most creditworthy borrower will not be able to borrow at a rate as low as the Federal Government pays on its obligations. We support retention of the 110-percent factor applied to the applicable Federal rates to determine the testing rate for whether a transaction has adequate stated interest. The factor is not punitive; in many arm's length lending transactions the market rate of interest would be 130 percent, 140 percent or more of the applicable Federal rate, due to the creditworthiness of the borrower.

Attached to this testimony are four charts which show the relationship between private and Federal Government interest rates over the course of the last 8 years. Chart 1 compares the FHA mortgage rate to a Federal long-term composite rate.[1] This chart shows a close relationship between the two indices during all periods, with the FHA rate consistently above the Government rate.

Chart 2 shows the ratio of the FHA index to the long-term Government index. In other words, this chart expresses the FHA rate as a percentage of the long-term Government rate. At no time during this period did this percentage ever drop below 110 percent and at times was over 130 percent. This relationship indicates that a test rate based on 110 percent of a Federal long-term borrowing rate is entirely appropriate.

Charts 3 and 4 provide the analogous comparison between the average prime lending rate and the average yield on new issues of 1-year Government securities. Again the correlation between the two averages is extremely high. Chart 4 shows that the prime rate was always at least 110 percent of the 1-year Government rate.[2]

We are well aware that legislation has been introduced, with the support of a number of the groups that will be testifying before this committee later today, to lower the test rate to 80 percent of the applicable Federal rate. We urge this committee not to adopt such change. Allowing taxpayers to state interest rates as low as 80 percent of the AFR would allow very substantial overstatements of true purchase price in sales of property calling for deferred payments. This overstated purchase price benefits both the seller, in the form of a conversion of ordinary interest income into capital gain, and the buyer, by converting interest deductions into depreciable basis that can be written off on an accelerated basis.

At current interest rates, a shift to a test rate of 80 percent of the applicable Federal rate would allow a basis overstatement in any sales transaction of more than 30 percent, assuming a purchase money loan for the entire sales price with a term of 30 years and level monthly payments over the term of the loan. For example, a building having a value of $10 million could be sold for over

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[1] The FHA mortgage rate is the rate charged to home buyers for FHA-insured mortgages. The Federal long-term composite rate index is based on yields of Government bonds with constant maturities of 10 years or more. The latter index is very similar to the Federal long-term rate of current law and was chosen in lieu of the Federal long-term rate because past data for the latter index are not readily available. Both indices are compiled from data published in Domestic Financial Statistics, a publication of the Federal Reserve Board.

[2] The data on the prime rate and the 1-year Government rate on new issues are also taken from Domestic Financial Statistics. Private borrowing rates are quite likely to exceed the prime rate, especially on lending transactions of more than 1 year (but not more than 3 years). Also, the 1-year Government rate on new issues will not be identical to the Federal short-term rate since the latter index takes into account all maturities of 3 years or less on all outstanding issues.

$13 million. In the case of loans calling for a single payment of principal and interest at maturity, the potential overstatement is far greater. For example, if the debt instrument described above called for a single payment at maturity, the same $10 million building could be sold for a purchase price of over $27 million.

For the tax law to permit distortions of this magnitude would be a substantial step in the wrong direction. A system using a test rate of 80 percent of the applicable Federal rate would present the worst of two worlds; the complexities of a floating test rate would be retained while one of the two major abuses that led to enactment of the 1984 act provisions, basis overstatement, would remain unchecked.

No blended rate for larger transactions: We do not believe that the test rate for small transactions should apply to any portion of the borrowed amount on a transaction above the small-transaction threshold. Our primary reason for opposing the blended rate approach of Public Law 98-612 is that there is no reason to provide a test rate which is below a market interest rate for transactions in excess of the threshold amount. The sole justification for the 9-percent rate for small transactions is that it is a fixed well-known rate that parties can use without reference to floating rates published periodically. This justification disappears as soon as the fixed rate is to be blended with a higher floating rate.

The blended rate also adds a significant amount of complexity to the imputed interest rules. For example, if a small transaction threshold based on purchase price is chosen, parties negotiating a sale of property for a purchase price in excess of the threshold amount will not know the minimum interest rate that needs to be charged because that rate will depend on the purchase price. Since the purchase price will depend in turn on the interest rate to be charged, the parties will be faced with a difficult interrelated computation that can be solved only through the use of sophisticated mathematical techniques. Similar problems would arise with a threshold based on seller financing.

Finally, a blended rate for transactions in excess of $1 million is not necessary to avoid a "cliff," that is, a dramatic difference between the tax consequences of a sale of property with a value just below the threshold amount and the consequences of a sale of property worth just over the threshold amount. In fact, a specific dollar limit based on either the stated sales price or the amount of seller financing essentially operates as a gradual phaseout of the lower rate.

To see why this is so, one must bear in mind that the right to state a 9 percent interest rate when prevailing market rates are higher allows parties to overstate the purchase price of the property sold. For example, if the prevailing market interest rate is 12 percent and the property is to be paid for in 10 equal annual installments, the purchase price of the property is overstated by a factor of approximately 13.6 percent. Thus, a sale of property for a $1 million note with interest at 9 percent on these terms would indicate a true value of the property of approximately $880,000. For property having a value of more than $880,000 but less than $1 million, if the small transaction threshold were $1 million of seller financing, the parties would in each case state a purchase price of

$1 million but would charge an interest rate between 9 percent and a market rate to achieve the correct economic result. Thus, the small transaction rule is advantageous until the rate that must be charged equals the rate applicable to large transactions.

The following table illustrates the correlation between the value of property and the interest rate that would be charged if the stated principal amount is $1 million.

[A table follows:]

	Stated sales price	Interest rate (percent)
Actual value:		
$880,418.26	$100,000,000	9.0
$899,889.28	100,000,000	9.5
$919,547.78	100,000,000	10.0
$939,390.94	100,000,000	10.5
$959,415.94	100,000,000	11.0
$979,619.91	100,000,000	11.5
$1,000,000	100,000,000	12.0

Mr. **Pearlman**. We recognize that, notwithstanding the above analysis, a perception remains that a cliff exists between the small transaction and large transaction rules. If this committee wishes to address this perceived problem, we would recommend a simple phaseout of the benefit of the 9-percent rate for transactions with a sale price between $2 and $3 million, or seller financing between $1 and $2 million, rather than a blended rate for all large transactions. This would simplify the system for larger transactions and would have the added benefit of limiting the revenue loss from the 9-percent subsidy rate.

Conforming the imputed interest rate to the testing rate: Under current law, if the parties to a sales transaction do not provide for interest at a rate at least equal to the safe harbor test rate, interest will be imputed at a higher imputed rate. For sales involving total financing of $2 million or less, the test rate is 9 percent and the imputed rate is 10 percent. To the extent the total financing exceeds $2 million, the test rate is 110 percent of the AFR and the imputed rate is 120 percent of the AFR.

This feature of current law is a carryover from old section 483, under which interest of at least 9 percent had to be stated to avoid interest being imputed at 10 percent. The original reasons for having different test rates and imputed rates, as well as the reasons for carrying this aspect of old section 483 forward in the 1984 act, are not entirely clear.

Whatever these reasons, Treasury believes that the system could be made simpler and fairer by setting both the test rate and the imputed interest rate at 110 percent of the AFR for large transactions and by setting both these rates at 9 percent for small transactions. The system would be simpler because fewer rates would have to be computed, published and assimilated by taxpayers and their advisers. The system would be fairer because parties would not be penalized for failing to provide the minimum interest rate required; the tax law would simply recharacterize the transaction as if this minimum interest rate had been provided.

Frequency of determination—semiannual or monthly: The 1984 act calls for semiannual redeterminations of the applicable Federal rates. Soon after enactment of the 1984 act, however, it became apparent that if taxpayers are to be required to state a market rate of interest, the system cannot work if the test rate is substantially out of date.

The 1984 statute calls for rates that are, on the average, 9 months out of date. Moreover, transactions taking place at the end of a semiannual period would be governed by a test rate based on interest rates in effect as much as 15 months earlier. For example, a transaction taking place on June 20, 1985, would be governed by a test rate determined in part by reference to yields on U.S. obligations during the month of April 1984.

As an interim measure, Treasury decided to address this time lag problem by providing in temporary regulations an alternate calculation of the applicable Federal rates, based on monthly rather than semiannual recomputations. This substantially reduces, but does not eliminate entirely, the time lag problem. The monthly rates were provided as an alternative to the statutory semiannual rates; the latter rates remain available in the event they are lower.

In moving from a semiannual to a monthly redetermination of the applicable Federal rates, we recognized that to some extent we were making it more difficult to negotiate and plan sales transactions. To ease this problem, we provided an additional special rule, allowing taxpayers in a given month to use the rates in effect for the preceding and the second preceding month, in addition to the current month's rates. This rule assures that, once a set of monthly rates is published, taxpayers can be assured that the applicable Federal rates will be no higher than those rates during a 3-month period.

We believe that the system of Federal rates computed on a monthly basis contained in the recently released temporary regulations strikes a reasonable balance between the need to reduce the time lag problem and the need to provide some planning stability to taxpayers. We urge this committee to adopt the system of monthly rates contained in the recent temporary regulation in lieu of the statutory semiannual system. We see no need to continue a dual system, especially since the statutory rates can result in substantial overstatements of basis in times of rising interest rates. More significantly, condifying the monthly approach of the regulations as the exclusive means for determining the applicable Federal rates would be far simpler than the current dual system.

Limiting the variation in the applicable Federal rate. It has been suggested that, whatever index is chosen for determining market interest rates, the index should not be permitted to increase by more than a fixed number of percentage or basis points from one period to the next. For example, it has been suggested that the applicable Federal rates not be permitted to increase by more than 10 basis points, 0.1 percent, from one month to the next. This proposal is sometimes referred to as placing a "governor" on the applicable Federal rates.

As the charts attached to this testimony indicate, when Federal borrowing rates increase or decrease significantly, market interest rates in private lending transactions faithfully reflect the increase or decrease. This applies to short-lived peaks and valleys as well as long-term trends. To deny this reality by placing a governor on the applicable Federal rates would simply give taxpayers an opportunity to understate true borrowing costs and overstate basis until the applicable Federal rates had time to catch up with the change in the market rates. Therefore, we believe that placing a governor on the applicable Federal rates is both unnecessary and unwise.

Alternate methods of proving adequate stated interests. As noted above, the function of the applicable Federal rates is to serve as an objective indicator of current market rates of interest for short-term, mid-term, and long-term lending transactions. However, even with a shift from a semiannual to a monthly redetermination of the applicable Federal rates, some time lag remains in the system. In times of rapidly falling interest rates, the market interest rate actually in effect at the end of a given month may be significantly below the applicable Federal rate for that month. This time lag is inevitable in any system under which test rates are computed and published on a periodic basis.

A related problem arises from the classification of all lending transactions into short-term, mid-term, and long-term for purposes of determining the applicable Federal rate. If an actual transaction has a relatively short maturity among transactions within its class—for example, a 1-year loan, a 4-year loan, or a 10-year loan—the use of an average yield for all maturities falling within that class may unfairly prejudice the relatively short maturities.

To take care of these and similar problems, we do not believe it is appropriate to attempt to make specific statutory refinements in the applicable Federal rates—such as weekly adjustments in the rate or narrower classifications of obligations by maturity. Such refinements would unduly complicate the system with only a minimum gain in accuracy. Instead, we think that taxpayers should be given certain opportunities to demonstrate that their transaction contains adequate stated interest other than by reference to the applicable Federal rate.

First, we believe that taxpayers should be permitted to compute and use indices based on the same principles as the applicable Federal rate but with greater accuracy than the published rates. For example, if a taxpayer selling property with the payment of principal due in 10 years could show that 110 percent of the average yield on 10-year Treasury securities was less than the interest rate provided in the sales transaction, the transactions would be treated as having adequate stated interest. Information of this type is readily available in weekly and monthly publications of the Federal Reserve Board.

Second, if a taxpayer can demonstrate that third-party financing could have been obtained by the buyer on the same terms as provided in the seller financing, the debt will be considered to have adequate stated interest. The taxpayer would have to show that this financing was available to a broad segment of the general public and that the buyer's creditworthiness would have allowed it to qualify for this financing; a mere letter of affidavit from a bank stating that it would have been willing to provide the funds on the stated terms would not be sufficient if no such loans were actually made on those terms.

Finally, sellers of fungible units of personal property on the installment basis should be given the opportunity to demonstrate that the financing contained adequate stated interest by showing that substantial numbers of the same item of property were sold for cash at the same price to other purchasers.

We believe that the regulatory authority in the current statute is broad enough to allow us to address these situations. However, we would welcome legislative confirmation of this authority on these particular points.

ASSUMPTION OF EXISTING INDEBTEDNESS

The last major issue that I would like to address today concerns the treatment of assumptions of existing indebtedness on property. The problem, simply stated, is that when property is sold and, as part of the consideration for the sale, the buyer assumes liability for an indebtedness with an interest rate that is below a market rate at the time of the sale, the same potential for overstatement or purchase price is present as in the case where the indebtedness is seller financing.

The problem may be illustrated by the following example. Suppose A, a commercial lender, lends $100 to B at 12 percent, which is a market interest rate at the time of the loan. B uses the $100 to purchase depreciable property and secures the note with the property. Sometime later, when market interest rates have risen to 15 percent, B sells the property to C. The fair market value of the property, if unencumbered, remains at $100. However, because C is able to assume B's favorable indebtedness C is willing to pay a total purchase price of $120, that is, C assumes B's $100 debt to A and pays B $20 in cash.

The extra $20 that C is willing to pay B has nothing to do with the value of the property sold; it simply reflects the fact that B's obligation to A is less of a liability because of the increase in interest rates. If the imputed interest rules do not apply to this transaction, C will be able to write off the extra $20 as depreciable basis. If the term of the debt is longer than the ACRS life of the property, this gives a significant advantage to C.

The seller B also benefits from the overstated basis in the following way. B originally owed $100 to A. When the property securing the debt was sold, B gave up property worth $100 in exchange for $20 in cash and C's assumption of B's debt. Thus, B's $100 debt to A was discharged in effect at a net cost to B of only $80. This $20 difference could be properly viewed as ordinary income from cancellation of indebtedness. Instead, unless the imputed interest rules apply to assumptions, C has additional capital gain of $20.

Possible approaches: Several possible approaches have been suggested for dealing with these problems. These may be referred to as the novation approach, the wraparound approach, and the antiabuse approach.

Novation: The novation approach treats an assumption as if the existing debt were repaid upon sale and a new debt issued by the original lender to the buyer. Thus, in the above example, the buyer C would have a depreciable basis of $100 and additional interest deductions of $20 over the life of the loan and the seller B would have ordinary income from the cancellation of indebtedness of $20. To complete the picture, the original lender A should be given a bad debt deduction of $20 to match B's income inclusion and would have interest income of $20 over the remaining life of the loan to match C's interest deductions.

Wraparound: The wraparound approach treats an assumption as if the seller remained liable on the original debt and issued new seller financing to the buyer. This approach has appeal primarily where the seller in fact remains secondarily liable on the assumed debt. In terms of the example, the treatment of the buyer C would be the same but the seller B would have interest income of $20 spread over the remaining life of the loan instead of at the time of the sale. The original lender A would be unaffected.

Antiabuse: The antiabuse approach focuses exclusively on the buyer C and attempts to foreclose the conversion of interest deductions into depreciation deductions in situations where this conversion would present a significant tax advantage. Under this approach, an assumed debt would be subject to the imputed interest rules only if the property securing the debt were depreciable in the hands of the buyer and only if the remaining term of the debt were sufficiently long, when compared to the ACRS life of the property, to indicate that the revenue loss from the basis overstatement would be significant. The seller and the original lender would be treated as under present law.

Recommendation: Each of the three possible approaches outlined above presents certain advantages and disadvantages. The novation approach and the wraparound approach both entail the matching of income and deductions and hence would be quite effective in preventing abuse. However, the novation approach is difficult to justify if the consent of the original lender is not required for the assumption. The wraparound approach would seem to be correct only where the seller remains secondarily liable on the assumed debt and presents significant issues relating to the timing of the seller's gain under the installment sale rules. Moreover, adoption of either of these approaches arguably would require a broadbased reexamination of fundamental principles relating to cancellation of indebtedness income, market discount, and other aspects of the taxation of financial contracts, an inquiry that would not seem advisable at the present time.

We would suggest, therefore, that the committee give its primary attention to the formulation of an antiabuse rule along the lines described above. We would be happy to work with the committee in the design of such a rule. Of course, the rule would apply only to assumptions of post-October 15, 1984, indebtedness. We see no reason to move this date forward since the antiabuse rule would apply to a more limited class of taxpayers than those covered by Public Law 98-612.

This concludes my prepared remarks. I would be happy to answer your questions.

[Attachments to the prepared statement follow:]

Chart 1

Private and Government Interest Rates

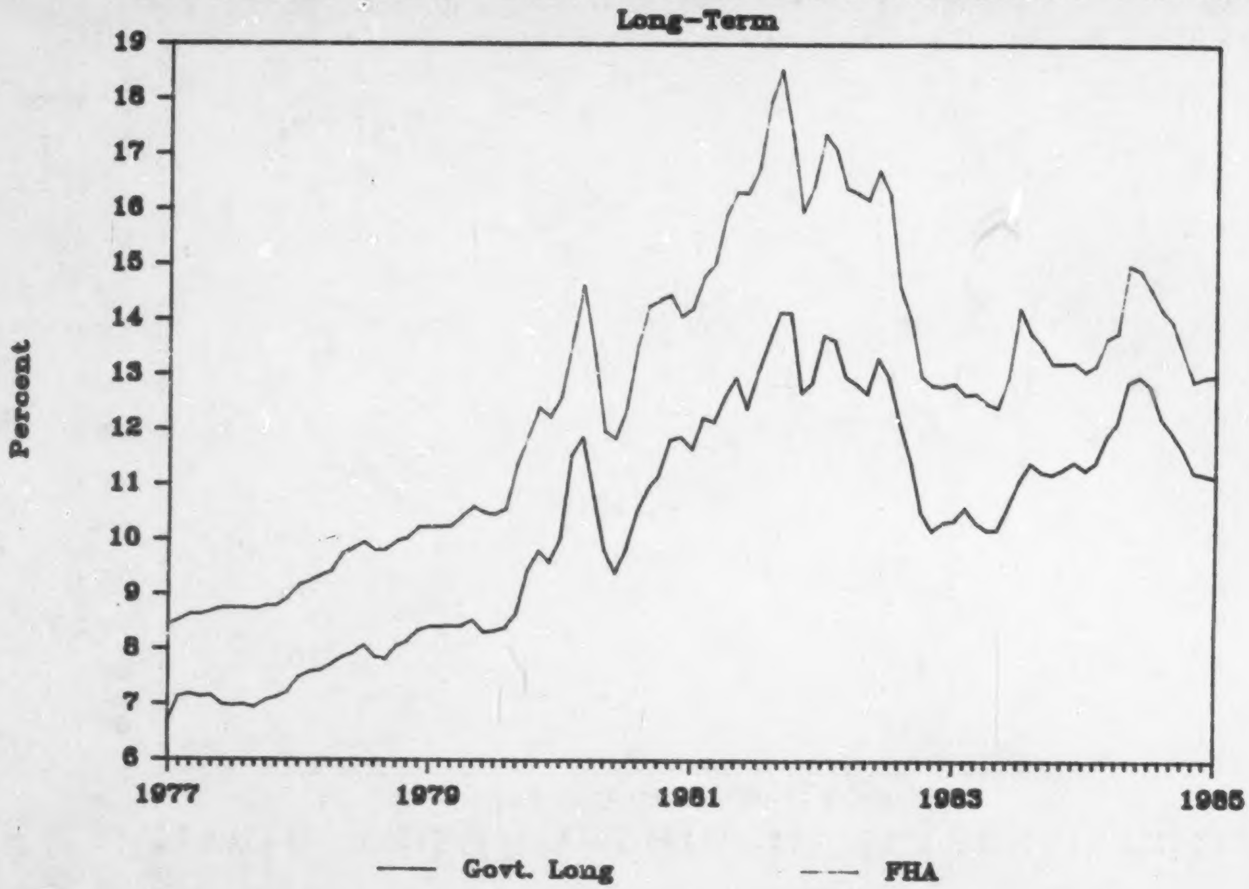
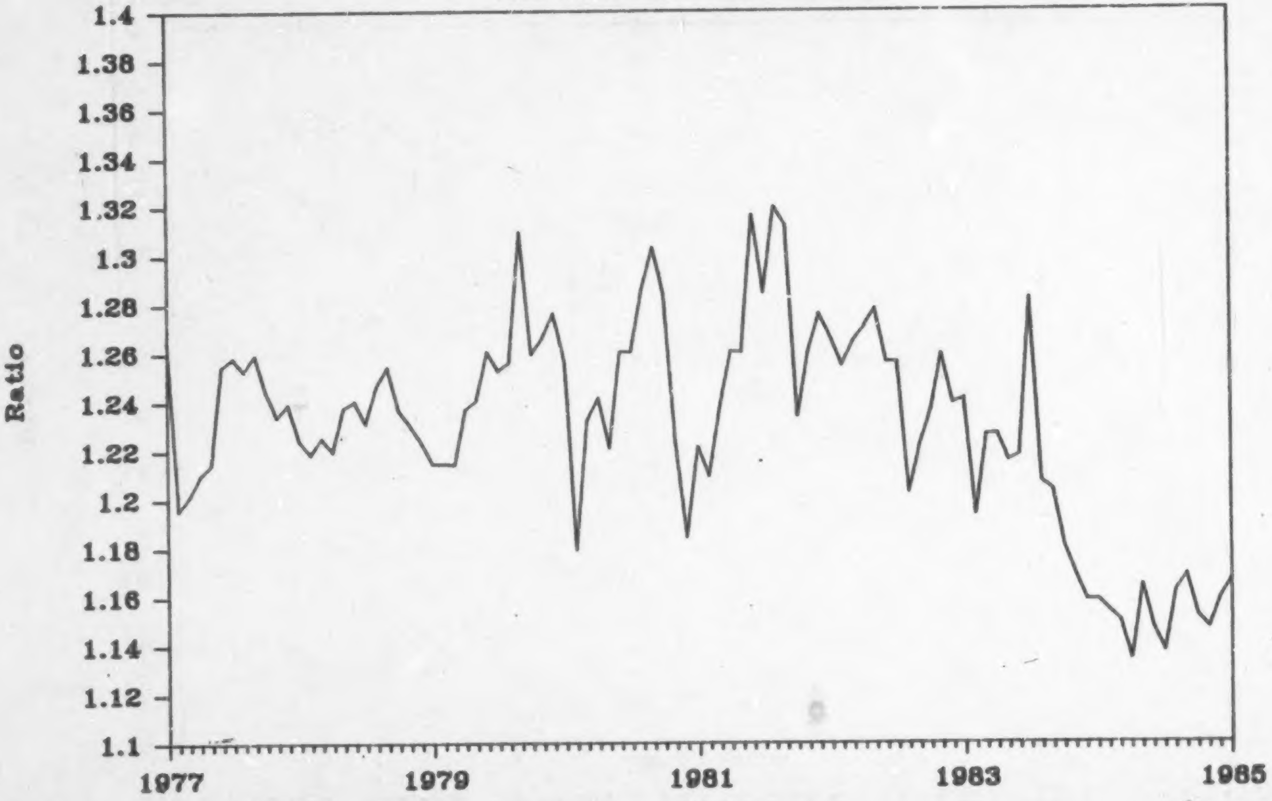


Chart 2



Private and Government Interest Rates

FHA Over Government Long

Chart 3

Private and Government Interest Rates

Short-Term

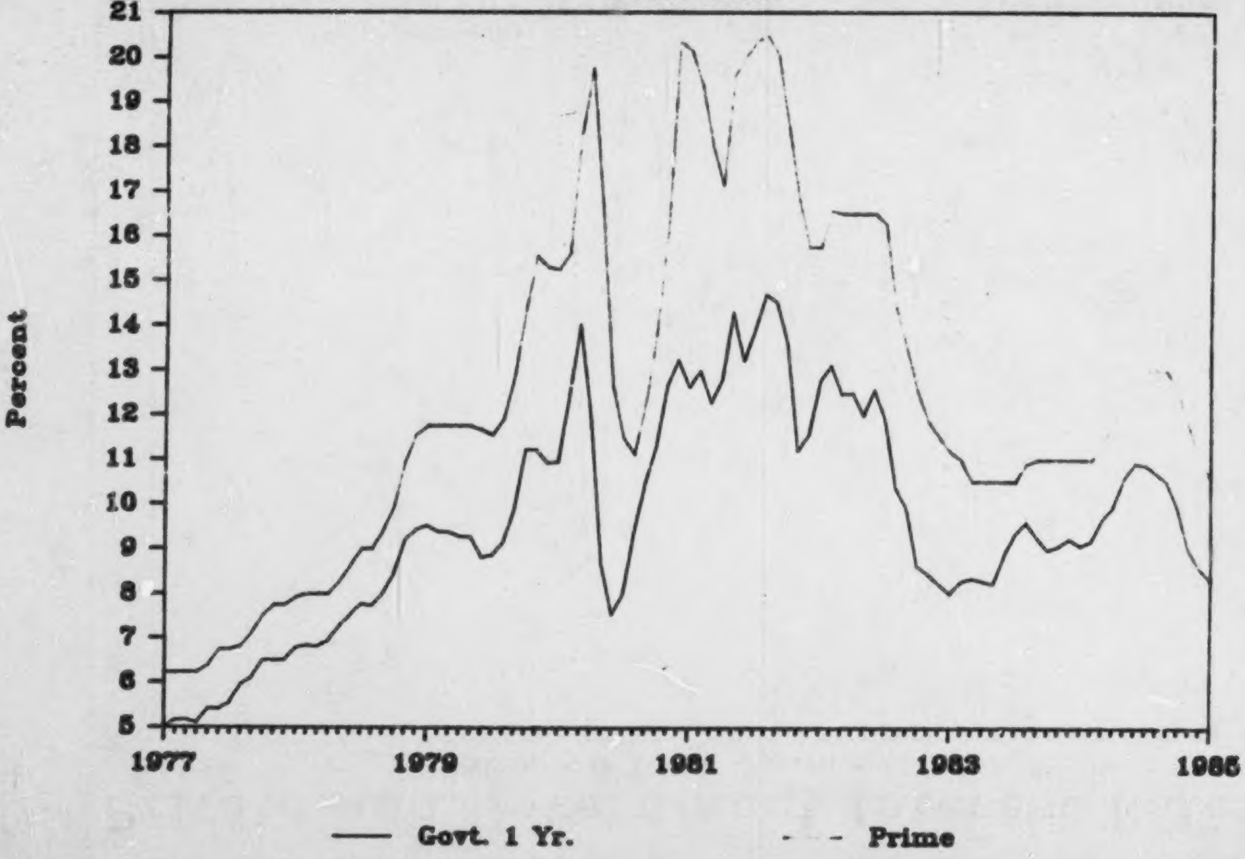
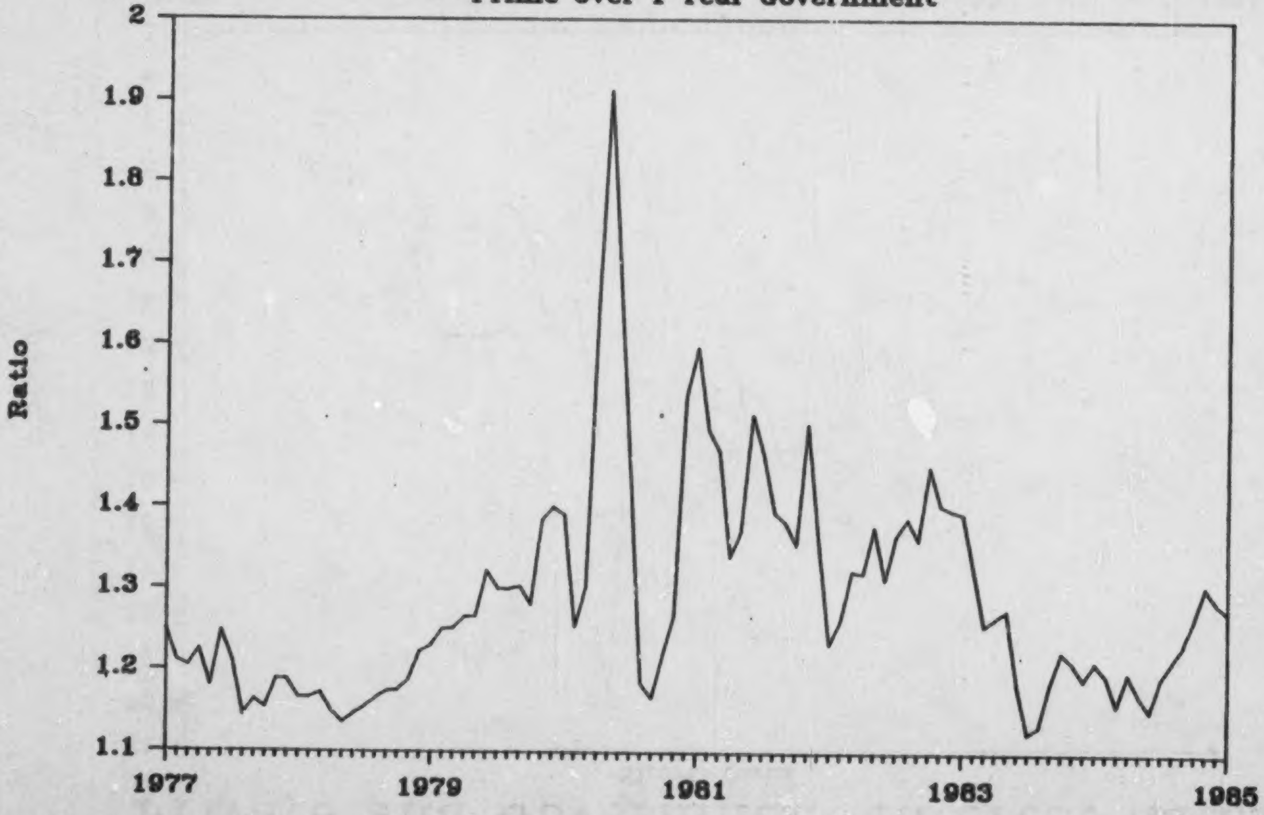


Chart 4

Private and Government Interest Rates

Prime Over 1 Year Government



Chairman **Rostenkowski**. Mr. Pearlman, what are the opportunities for tax avoidance if both buyer and seller account for a property sale on the so-called cash-cash system?

Mr. **Pearlman**. Well, our concern, Mr. Chairman, is what we anticipate will come—we all view as a vanilla transaction. When we talk about a cash-cash transaction, we tend to think of a buyer and a seller, and they decide between them that they are both prepared to be on the cash method—that sounds very simple. And we say, of course, let us include a cash-cash rule and that makes life easy for everyone. We have to then go forward and say, OK, what if one of those parties no longer stays as a party to the transaction? For example, what if the seller of the transaction transfers that obligation to a tax-exempt entity, and that tax-exempt entity then turns around and transfers that obligation to what might end up to be an accrual basis taxpayer.

What I am suggesting by that, we point out some other examples in our written statement that it is just not as simple as the transaction of a buyer and a seller, and those two sellers being on the cash method. We know that properties are going to be transferred and that debts which have been originally labeled as the cash-cash debts are going to be assumed, and we know that obligations that are originally viewed as having been accounted for on the cash method are going to be assigned or sold or discounted. And so the complexities and the abuses come in what happens after I referred to as the vanilla transaction. We do think there are abuses as the obligation moves away from the original seller of a transaction.

Chairman **Rostenkowski**. Mr. Secretary, does the applicable Federal rate give some protection against highly volatile changes in the interest rate to allow prudent business planning?

Mr. **Pearlman**. Mr. Chairman, I think that there are two responses to that question.

First, I find that the data that we developed on the tracking of private financing rates of the Federal rate is very constructive. One of the things that the committee should be legitimately concerned about, do the Federal rates, are they reflective, timing wise I am talking about now, of private financing rates. And we have shown a couple of those. We have looked at the FHA rate because it is the lowest of the housing loan rates, and we have looked at the prime rate as being sort of a standard conventional rate for long-term obligations. And what we found was it does give protection. There is another piece of that, and that is the temporary regulation that I referred to in my statement.

When we decided that we wanted to give taxpayers the ability on a shorter term basis to calculate what the applicable Federal rate was, we gave them the ability to make sure when they negotiated the transaction in May to be sure that that rate was closer to what the real world was in terms of the real interest rate than what the rate might have been in January when the real interest rate was set. And my answer to your question is with some sort of short-term ability of the taxpayer to determine the rate, and our recommendation is to allow for taxpayers a monthly ability to redetermine the rate. Yes, I believe the applicable Federal rate does give reflection of actions.

We have a set of original issue discount regulations that go well beyond contingent payments that really deal with the 1984 act changes in their entirety in the rather advanced draft stage. I would prefer, if you do not mind, rather than giving you a date today that may be meaningless, to respond to that question a couple of days from now and give you a date that is more reliable. But those regulations will contain a suggestion of how to deal with contingent interest, and I think frankly the contingent interest rule that we are talking about is a rule that will——

Chairman ROSTENKOWSKI. Well, Mr. Secretary, if you will keep us informed, I am sure the committee will appreciate that.

Mr. PEARLMAN. I will keep the committee informed and supply a date when we expect the regulations to be published shortly.

[The following was subsequently received:]

DEPARTMENT OF THE TREASURY,
Washington, DC, June 17, 1985.

HON. DAN ROSTENKOWSKI,
Chairman, Ways and Means Committee, U.S. House of Representatives, Washington, DC.

DEAR CHAIRMAN ROSTENKOWSKI: During the April 24, 1985, hearing on the original issue discount (OID) and imputed interest rules, you inquired when the Treasury Department would issue regulations under the relevant provisions of the Internal Revenue Code.

We expect that a set of proposed regulations under sections 1271 through 1275 of the Internal Revenue Code, covering many of the major issues (including the treatment of contingent interest payments), can be published by July 31, 1985. If Congress passes legislation before that date modifying the OID and imputed interest rules, we would strive to incorporate as many of the changes as possible. Because of the relatively short period of time remaining before July 31, 1985, however, it might not be possible to reflect certain of the changes in the first set of proposed regulations.

I hope this information is helpful.

Sincerely,

RONALD A. PEARLMAN,
Assistant Secretary (Tax Policy).

Chairman ROSTENKOWSKI. Mr. Secretary, does the President's budget anticipate any revenue loss in the area of imputed interest?

Mr. PEARLMAN. We do not, Mr. Chairman. The budget obviously for fiscal year 1986 reflected the stopgap amendment, but the budget was compiled on the assumption that the stopgap would expire at the end of June.

Chairman ROSTENKOWSKI. In other words, the budget does not anticipate a revenue loss of $1.8 billion?

Mr. PEARLMAN. We recognize that any legislation that creates a permanent small transaction is going to create a revenue loss. The point I really intended to make in responding to your question is that the budget projection did not assume a revenue loss because the budgeting process did not assume any kind of an act of legislation.

We think in fact, indeed, there will be a revenue loss. It could be in the range of a $1.8 billion. Indeed, it could be higher. We are in the process of trying to put some revenue estimates together at this point in time.

Chairman ROSTENKOWSKI. I appreciate that, Mr. Pearlman. I woke up this morning to a clarion call that we balance the budget, that we attack the deficit, that all of us are equally to share that responsibility. I anticipate that all of us will shoulder the burden that is necessary to attack the deficit without going further into debt in one area or another.

Mr. Duncan will inquire.

Mr. PEARLMAN. Mr. Chairman, I would like to just add a word in response to that comment.

You opened this hearing by saying you were deeply concerned about the deficit, and I want to make it clear to you in this context we too are deeply concerned about the deficit. We too are concerned about revenue loss.

Chairman ROSTENKOWSKI. Mr. Pearlman, we all are. Everyone in this room is I am sure.

Mr. Duncan will inquire.

Mr. DUNCAN. Thank you, Mr. Chairman.

Mr. Pearlman, do you believe that the revenue cost of whatever proposal is drafted should be an important consideration in shaping those proposals, and along those lines to what extent do you believe that we should attempt to offset the revenue loss with a proposal of a revenue raising nature?

Mr. PEARLMAN. Mr. Duncan, I do believe that revenue loss should be an extremely relevant consideration in designing a permanent solution. It is not the only consideration obviously, but I view it as an extremely important solution. I do not think that we are at a point, and I am not really trying to be evasive. I do not think we are at a point in suggesting how to deal with revenue loss. I think that a better way to proceed is what kind of a permanent solution to the small transaction problem do we think makes good sense from the standpoint of simplification economic sensibility, find out then, put our revenue estimators to work, and find out what that would cost and then determine whether we can afford it either through some kind of revenue enhancement or whether we are going to have to cut back that solution. So I think at this point it really is impossible to suggest what we might do to pick up revenue because we do not really know what the solution is going to look like.

Mr. DUNCAN. Suppose we reach a stalemate? Do you have some specific suggestions as to what provisions might be looked at to balance off the revenue loss other than what you have just said?

Mr. PEARLMAN. I hope we will be in a position, once we get a better handle on, (a) what the specific proposal is, and (b) what the revenue proposal is.

Mr. DUNCAN. Suppose we cannot? What about your regulations, can you deal with them before the June date when the stopgap provision expires?

Mr. PEARLMAN. There are certain issues that we can deal with in the regulations, the contingent issue that the chairman referred to. Obviously we would intend to continue the monthly calculation of imputed interest as an option to taxpayers, which was contained in temporary regulations. We think that has received a very positive response from taxpayers, but it is equally as obvious that we cannot provide a carveout by dollar amount of small transactions by regulation. We would simply have to follow in that regard the rules of the 1984 act.

Mr. DUNCAN. How do you respond to the allegation that the implementation would substantially disrupt and, in many cases, entirely stop the economically motivated seller-financed estate transaction?

Mr. **Pearlman**. Mr. Duncan, I really believe that that is not true. But I also believe, after having discussed that issue——

Mr. **Duncan**. Would you say on what you base your assumption?

Mr. **Pearlman**. My judgment is that large transactions or small transactions, buyers and sellers of homes, of businesses, of other kinds of assets, understand interest rates, and they understand purchase price, and that even though perhaps a wholesaler in a market which is in a high interest rate market may not consciously think about whether he is selling his home for less when he agrees to take back seller financing. He knows that he is economically detrimented to some extent. He is getting less money if he had sold his home at a reinvestment price if he had reinvested that money. I think that people understand that. And we are not fair, and we shortchange people when we conclude that they do not really understand the economics of the transaction. They may not know how to talk about it. They may not understand how to understand the imputed interest rule. I think we found that.

We have seen how people, for example, have gone to a variety of routes of sophisticated floating debt transactions. We have seen how people have invested in floating money market rate instruments. I really believe that people really do understand the relationship between interest and sale price, but I must say I do not think I will be able to persuade our adversaries of that fact.

Mr. **Duncan**. My time is up.

I may submit questions, Mr. Chairman, for the record.

Chairman **Rostenkowski**. Without objection, so ordered.

Mr. Matsui will inquire.

Mr. **Matsui**. Thank you, Mr. Chairman.

I would like to thank you for conducting these hearings. As you indicated last year, you were planning on holding hearings before the expiration of the temporary rules. And I appreciate your efforts to do that at this time.

I would like, if I may, Mr. Pearlman, to pursue the issue of revenue loss.

I agree with the chairman and others on this committee that we have to discuss this issue in the context of the deficit. I do, however, also realize that the seller financing involves about $30 billion with rental, commercial, and industrial sales in this country, and these sales contribute about $6 billion to the GNP, and they represent about 120,000 jobs and about $2 billion in terms of Federal and State revenues. And you have also mentioned in your closing comments to Mr. Duncan that we have a tendency to underestimate the American people, that we assume they do not understand economics or economics of transactions. And I am hearing from the real estate industry of the United States, and I am assuming we should not underestimate them. They say that you will see a major dropoff in many seller financing situations if we do not make some changes in the rulings.

Now, I am a supply sider after 1981, and we made some rather significant cuts in ACRS in terms of depreciation.

Now, I have assumed new supply-side theories of economics, that if we do not change these rules, we could have a rather drastic drop in these small transactions. If we do change these rules, it will result in more Federal revenues. And again I have to go back to the American people. I believe they do understand economics, and some of us inside the beltway forget to realize that these people do have an intelligence, and do in fact understand economics and have a good reason to believe that your current rules will result in a major dropoff hence a major revenue loss. And I have made this comment on that because I think you have a place to respond to this.

Mr. **Pearlman**. Mr. Matsui, I do not think I find myself in disagreement very much with what you have said.

Mr. Duncan asked me the question of whether these rules—at least I understood Mr. Duncan's question as asking whether people could structure transactions understanding the issue of the discount. And I think your comment underscores what I tried to respond to that question.

I do believe that people utilize economics. And I think what people are telling us, including people in the real estate industry, people are not going to like to structure deals in the imputed interest rate, but they do not like the tax consequence that flows from that. I do not think that that is bad. I think there is some merit in saying that in smaller transactions that there is a desire of tax policy for saying, look, we do not care about the revenue implications in a certain category of transaction. I do not personally find that troublesome. But if we go down that road, we have to acknowledge that that is going to have an effect on an estimating basis, which we all use, and we use on a consistent basis. That is going to have a revenue impact.

Mr. **Matsui**. I think you have every responsibility and we do try to eliminate fraud and abuses in the system. If people are acting normally and acting reasonably and in good faith, and they have to take the tax consequences, we cannot govern all behavior in the United States. And people focus on interest rates.

If you look at the newspaper today, you will see GM, Ford, offering 8.8 percent interest rate on automobiles. I imagine you are going to go after them next. But people focus on interest rates, and they become very important. And as you say, a lot of time, people do not make decisions based upon the Tax Code but based upon other reasons. And I think interest rates during the time of high rates become very important.

I have a couple more questions.

Mr. **Gibbons** [presiding]. Since you are the author of the proposal, I think we could give you a couple of minutes here.

Mr. **Matsui**. I appreciate that very much.

Mr. **Pearlman**. Mr. Matsui, I share your view, and that is why I believe it is desirable to carve out categories of all transactions and say—let me just suggest to you, though, that these arguments which I find very persuasive, do not argue for extending to large transactions the rules for small transactions. That is one area where we have a serious problem.

Mr. **Matsui**. You indicated in your testimony about mismatching for accounting, and I agree with you that that is a problem. And I agree that that could be an abuse.

The proposal that I introduced last week would make that consistent, I find that many small transactions are done on a cash basis, just on the basis of convenience.

You indicated that you have it in your testimony, but could you explain why you could not accept an agreement where there was no mismatch? It seems to me that that would not make much difference to you.

Mr. **Pearlman**. Well, the first thing, I think it is very important, I think, for all of us to realize what I think is the actual fact, and that is the vast majority of sales transactions this is all academic because the interest is paid currently. And if we set a 9-percent rate and the interest is paid currently, you never get into the discount. So you now talk about what will be a relatively small number of transactions under whatever our threshold is under which interest is not paid currently—and what I tried to do when I responded to the chairman's question is to say if we are only talking about the first buyer and first seller—your rule is a good simple clean rule, but we know it is not going to stop there. We know that in the normal course of things that the property which secures cash obligation is going to be sold before the debt is paid off, and that debt is going to be assumed, for example. What if it is assumed by the accrual basis taxpayer? What does that taxpayer do? Or take the other side of it. We know that the seller of the property, who has a cash obligation, may not hold onto it. He may take it down to his bank and discount it. He may sell it in the market.

What happens if it happens that the person to whom he transmits it is an accrual basis taxpayer? All I am suggesting is if we go to a cash-cash rule on the theory that that is going to be simple, I can assure you—and my guess is that you would ultimately agree with me, that we are going to have to put some backups in that rule to deal with a potential tax shelter type of problem. And that is going to make that rule very complex. So what seems like a simple rule to begin with may not end up as a simple rule. And it is in that context that we suggest that you not go down that road.

If the committee chooses to go down that road, then we are going to have to deal with those problems.

Mr. **Matsui**. You are speaking of the complexity and trying to follow the chain, is that correct?

Mr. **Pearlman**. Yes. And walking around the cash-cash rule.

Mr. **Matsui**. If we deal with that issue, you would not have any problem. And you deal with it if it becomes complex?

Mr. **Pearlman**. I think there are two levels: (a) we know there is going to be some difficulty in dealing with the issues we have identified and, (b) can we deal with the type of transactions that we cannot anticipate, but I do not want to suggest by that comment, Mr. Matsui, if that is an area that the committee wants to pursue, we will work with you.

Mr. **Pickle**. Mr. Secretary, good to see you. Quite often when we get into tax reform, we just exhaust ourselves in trying to overdo something that is pretty simple. This imputed interest question may be one of those type things.

Many people think we actually are invading the individual's right to sell his own property. When we try to correct an abuse, quite often we get so involved that we overdo it.

I hope that we can get this issue before this committee and get it out and get it behind us.

What applicable rate is acceptable on this overall issue? Our colleague, Mr. Matsui, has proposed a test rate of 80 percent of the Federal applicable rate. You say that is too low. That would not be the right approach. You give the example, using the 80-percent rate, if you had a building valued at $10 million, that the building could be sold at $13 million. You say that is too much leeway.

Suppose we take a 90-percent applicable rate. Could you give me a sort of a seat of the pants estimate as to what that would mean to us? You said the other would be about a 30-percent basis overstatement.

Mr. PEARLMAN. The guess is it would be somewhere between 13 and 20 percent over stated range, but we could easily provide that to you.

Mr. PICKLE. It would be roughly cut in half if you used that figure. And if you went up higher, it closes a little bit more.

Mr. PEARLMAN. Right.

Mr. PICKLE. I would hope you would try to be as practical and as liberal as possible and get this issue out of the way.

Now, I want to ask you one more question. What is the magnitude of overstating the basis when we do not pay interest currently?

Mr. PEARLMAN. Well, obviously, when interest is not paid currently, that increases dramatically the magnitude of basis overstatement because again it is deferral of the interest. It depends on what rate you set. It is really the interrelationship of the time the interest is paid and whether it is 100 percent or 80 percent. But the magnitude is dramatic the lower that test rate and the longer the deferral, and we suggested—the $130 million example you gave was one where there was current interest being paid, if you push out the maturity of interest under that same example, you more than double——

Mr. PICKLE. Does your testimony give some example to the——

Mr. PEARLMAN. Taking the example you used a moment ago, a $10 million sale price, using a 1½-percent interest rate for 20 years, I may be wrong in recollecting the example, the sale price of $27 million, the basis overstatement was more than——

Mr. PICKLE. That is on the basis of a cash elections, is it not?

Mr. PEARLMAN. On the deferral of interest on maturity.

Mr. PICKLE. Well, if you want to give us some further examples of that basis being overstated, we will be glad to have them. But many of us are generally in favor of something like Mr. Matsui proposes. We want something done quickly, and we want it out as quickly as we can because it is affecting too many people in their work.

Mr. PEARLMAN. If my prepared comments did not reflect it, we share your desire. We want to get it behind us too. We want to work with you. We think efforts by all people in the real estate field and others trying to deal with this issue over the past year, I think if we all exert some reasonableness, we will be able to get rid of this quickly.

Mr. **Pickle**. I hope so.

Mr. **Gibbons**. Mr. Gregg.

Mr. **Gregg**. I was wondering, Mr. Secretary, if you could explain to me briefly whether any of your proposals will impact intrafamily loans under 483(f)?

Mr. **Pearlman**. Mr. Gregg, there is another set of rules that is of no interest or below interest loans. The so-called free interest loan rules that were enacted in 1984, and they have some impact on inner family transactions. But if you are talking about sales transactions, not gift transactions, nor compensatory transactions, then the normal rules would apply. And whatever is set, they would apply, and you would have the interest free loan rules. And it is possible, I would want to think, and I want to think about that and give you a more careful response to your question that you might have as interest-free loans come into play.

For example, for some dramatically reduced rates between a father and son where it is made a gift to the son, so an interest free loan might come into play in some of those situations.

I would be happy to respond more carefully though.

Mr. **Gregg**. Because, as I understand it, under the interest free loans, the interest rate would be 1 percent, but they could get 7 percent if there was a fee arrangement, about 100 percent——

Mr. **Pearlman**. The test rate is different, and one of the things we would like to see come out of this exercise is make those rates consistent.

Mr. **Gregg**. If you have a gift situation where you are computing interest as part of the gift——

Mr. **Pearlman**. I think it would be desirable to have it consistent. I must confess if the committee says it is going to end up as 80 percent of the Federal rate, then you will not find us terribly interested in applying that in the interest free loan area. But if you come up with a rate that bears a relationship to the real world, I would like to see the same rate applied to loan transactions. I guess it depends on what kind of action the committee takes in this area. My hope is that with respect to large commercial transaction, over whatever the threshold is, it is very difficult for those people to argue, in my judgment, they may not share that view, that 110 percent distorts the economics of those transactions.

In the below threshold area, obviously there has to be a discount rate. If we talk about 100-percent rate in the interest free loan area that has some relationship, then I would hope we can try to make these rules consistent. I think it is desirable to try to do that.

Mr. **Gregg**. Thank you.

Mr. **Gibbons**. Mr. Archer.

Mr. **Archer**. Thank you, Mr. Chairman.

Mr. Pearlman, I understand the responsibility that you have in the position you have in the Treasury, to try to bring in as much revenue as possible, particularly when we have the deficit that we have. You and I have talked many times about this problem. I still worry considerably as to any approach the Government takes to fictionalize anything. It is extremely complex for most people, who don't understand it. An elderly widow came to me recently. She had a small amount of preferred stock. The company in which she had the preferred stock made a changeover, to give her a debenture in exchange for the preferred stock. The company was in trouble. The question in her mind was should I elevate a sequence of debt by taking the debenture, which would be above the preferred stock. On the other hand, the company said if you accept the debenture you will be susceptible to the OID rules and you will have to compute interest, and we are not certain what amount of interest, from the debenture. Now, my goodness, where have we gone in this country? What are we doing to individual taxpayers in this country? I don't understand why there should be OID in that situation, but there is. And those things that we are doing in the name of tax reform, it is as if we have got to tax every possible thing that comes down the pike. You could very easily say that in the theory of the Treasury when it put this imputed interest into the bill in the first place in 1984, we sure should tax these automobile loans that are being made at below market interest rates, because they are raising the price of the automobile, and where are we going to stop this? Is the real price of property what people pay for it at what you say is a reduced interest rate? Is that the real price of the property or is the real price what they pay at an interest rate that is above what the interest rates really ought to be in the marketplace? Who is going to make that judgment? That is a subjective call.

When interest rates were 20, 20½, 21 percent, was that a realistic barometer of what that property was worth on a long-term basis, when you entered into a long-term deal? We didn't have any problem with this "imputed interest" when interest rates were at a reasonable level, relative to the rate of inflation. So what is that property really worth? Is the worth what the tax assessor puts on it, what the appraiser puts on it? Say you get a guy who comes in and says I'll make you a cash deal for this, and later he backs out of the contract. You then sell the same property to somebody later at an interest rate that is 10 to 11 percent.

What is the real value of a piece of property? We are moving down the path of fictionalizing what is occurring in our society because we have to get more revenue, and I understand your problem. I want to pursue just a minute what Mr. Matsui was getting into, and that was the revenue estimates. I understand the constraints within which you are working, and we are making these estimates on the traditional way of estimating revenue, but that has been proven wrong time after time.

What are you getting in the way of revenue today from the windfall profit tax, in terms of what you projected you were going to get? And you can go on and on and on because we do not set out realistic estimates.

And what you are doing here in imputed interest is going to have a major effect on the situation in the marketplace. I think we have really got to understand all these practicalities. I understand where you are coming from. I would like to ask you one or two specific questions. Would you have any objection to the exempting of all residences from the imputed interest rules?

Mr. PEARLMAN. Well, sometimes——

Mr. ARCHER. Is that where the abuses are, or might we look at this on the basis of simply exempting residences.

Mr. PEARLMAN. The problem is the preference. The problem of responding to the question is the preference. We do have a fundamental disagreement between us, our respective position is that I do not believe that if we use extreme exemptions and very low rates of interest, and very inflated rates of purchase price, or some other way around, you and I would agree that something was economically wrong with the transaction.

If I told you a $10 million home was being sold for 2 percent, is that home really worth $10 million. I would think that at some point there is something funny going on between those parties. Sometimes it makes more sense, for two reasons. No. 1, because we should be talking, I think, about smaller transactions where the level of the sophistication of the parties is lower, and 2, because it is simpler to have a generic rule, and to draw that line and let them apply to all those problems, whether it is a million dollars, $2 million or some other. My preference, and I think it is in the taxpayers' interest to set the rule, and if the committee wishes to see it, and apply it to everyone and not superimpose on top of that rule another rule for residences. My preference would be to have a generic rule to where the committee chooses to set it, and that applies.

If you have a $4 million residence, and you set a $1 million line, or $4 million line, then that $4 million residence would not be eligible, but in my view, in my judgment, the seller of a $4 million residence should be aware of interest rates, what is involved in pricing property, and setting a rate on a man's property and there is no reason to give us a specific exemption for that.

Mr. ARCHER. That is mainly perception and not revenue impact, as I understand what you just said.

Mr. PEARLMAN. I think it is unfair to characterize the imputed interest rules as only revenue raising rules. I think as we go down this difficult road, we did it several hundred times in the 84 act, some of them raised very substantial amounts of money, and some of them did not. I believe there is a serious perception problem here. I think that originally drove us to the imputed interest rules where the tax shelter transactions, and they weren't all $100 million transactions.

I think there is a perspective issue here, and I would not want to represent that an example for residences is a revenue issue. I think we have to be sensitive of the perception of such an exemption.

Mr. ARCHER. Let me get back for 1 minute to the question of where the rates should be set. If you are going to have a long-term rate at 110 percent of the current applicable Treasury rate, which is what you recommend, it would produce to date as of April of this year, 13, almost 13½ percent interest. Conventional loans today are less than that. If you don't charge more than the conventional loan rate, you are going to be penalized and you are going to have to report interest nothing short of 14.75 percent of nothing.

Now, how can that be justified? A VA loan is 12½, but conventional loans are running—I have seen conventional loans at 12⅛. You want to compute a rate that is higher than that, penalize a person if they don't charge more than that, and run them up to 14.75 percent?

Mr. **Pearlman.** I think the issue of setting a rate and trying to get a rate that reflects the real market is a tough issue. We tried to develop some data to show that conventional financing, using the FHA rate, we thought that was pretty conventional, went nowhere near 110 percent. We saw 112, 14 percent, and in most cases, it was dramatically above 100 percent. I think arm's-length financing that is below 100 percent is relevant. It is a line drawing issue and I don't want to be offensive about it. I think we should, Treasury, and all of us should be prepared to look at all the things. We presented some data to the committee. Maybe there is some data out there that is different.

Mr. **Archer.** Thank you.

Mr. **Gibbons.** Mr. Stark.

Mr. **Stark.** Thank you, Mr. Chairman. I am sorry I missed your testimony, and if this has been covered, tell me and I will withdraw the question in the interest of saving time. I have a perception that there are two sorts of abuses that the imputed interest rates are dealing with. One is the interest rates on $1 million. Somebody is going to have a little higher capital gain, somebody is going to save a little interest, but I am not sure that that is as big an abuse as the situation where you build, say a $100 million transaction, you have a $100 million depreciable base, are there two kinds of groups of abuses that you are looking at, and is it where you build the depreciation base much higher than changing around the interest rates as between smaller transactions between buyer and seller?

Mr. **Pearlman.** Mr. Stark, there are two kinds of abuses, and they are the interest rate, the average of the interest rate, that is the vehicle for determining whether or not there is a basis of overstatement. The example I used in the statement was that at 80 percent of the adjusted rate, there is about 30 percent, using current interest rates, the current adjusted Federal rate, there is about a 30-percent basis of overstatement. That is pretty dramatic. In relative terms, it is more dramatic than on absolute terms, and there is a time problem and that creates the potential for overstatement as well.

Mr. **Stark.** But in residential property, it doesn't really make any difference, does it, except possibly for capital gains.

Mr. **Pearlman.** On the residential side, it is conversion or perhaps exemption, because most times——

Mr. **Stark.** And in large agricultural properties, it generally doesn't amount to much.

Mr. **Pearlman.** Well, just pure land, you are not talking about a basis that is going to be depreciated, but—in addition to that, that is what I meant, talking about the basis of the overstatement, but we can't lose sight of the mismatch on deferral. Is one talking interest? That is the original issue discount, I think both of these issues are going to be more serious in that larger transaction, and less serious in the sale of a residence.

Mr. **Stark.** But I think the problem rests more with the basis change in the interest.

Mr. PEARLMAN. I guess I could try to go back and pick out the pieces and say it determines on what the terms of the transaction are. I think the relationship of interest to the market rate, and the timing of the interest deduction are both very significant problems.

Mr. STARK. Thank you.

Mr. GIBBONS. Mr. Gradison.

Mr. GRADISON. Thank you, Mr. Chairman. Mr. Secretary, my special concern with this is revenue neutrality. We have estimates in excess of $1½ billion in the cost of this. At this stage, I just want to ask one question, although we want to go back and forth a little bit about it, but will you be willing to work with us in suggesting an alternative means of raising revenue from real estate transactions to pay for this in the event that the Congress decides to go ahead with the change in cost, let's say $1½ billion, $1 billion?

Mr. PEARLMAN. We are concerned about revenue losses in this proposal.

I would hope that as the committee refines its thinking, and gets to a position where the revenue estimaters on my staff then come in and say, all right, that provision costs *x* numbers of dollars, that we will be able to report that back to you promptly. Because very frankly, at this point in time, I wouldn't know what to ask them.

Mr. GRADISON. I think that is entirely fair.

One related question. I recognize that we have a commitment to deal with this issue soon. I also recognize that there is a need for certainty in the marketplace about what the rules will be, and maybe those two factors argue that we should go ahead and handle this separately.

I understand that. But at the same time, with so many questions related to real estate taxation being very much up in the air in the context of tax reform, I wonder whether it wouldn't be wiser to fold this issue into our consideration of a tax reform package, rather than pulling it out for a separate consideration.

What is your advice on that?

Mr. PEARLMAN. I think it would be unfair to taxpayers to do that, and I think we can't ignore the fact that the stopgap measure is going to expire shortly and we have to deal with that. We owe people that.

Mr. GRADISON. Thank you, Mr. Secretary. Thank you, Mr. Chairman.

Mr. GIBBONS. Thank you.

Mr. Dorgan.

Mr. DORGAN. Thank you, Mr. Chairman.

Mr. Pearlman, when we originally dealt with this issue on the Ways and Means Committee, we had some discussions about it, and I just want to ask you some, I guess, philosophical questions.

The problem that we have in collecting taxes is that we create rules so intricate and so difficult that you don't have time to play the economic game in America, because you spend all your time keeping score. And I indicated to you when we originally dealt with this that I have been involved in seller financing on very small businesses. I own a small apartment building, and I know what seller financing is because I have been involved in it.

And in most instances, the casual seller financing throughout the country has nothing at all to do with anything other than making the deal happen. It has nothing to do with trying to change the basis, or converting a lower interest rate into a higher property value. It has nothing to do with that at all. In most instances, it has to do only with making that transaction take place.

Now, there are some cases where people putting together syndications have done some very sophisticated things to abuse this situation, and they have tried to convert terms into price and, therefore, convert a higher asset value into a more advantageous tax break. I understand that as well, and I agree with Treasury that we ought to do something about that.

I don't agree with Treasury that we ought to create conditions that interrupt those casual transactions. Especially at a time when we are concerned about high interest rates, the last thing we want to do is to create public policy that attempts to increase interest rates on certain types of transactions here.

Isn't there a way for us to treat the abusive situations from a tax standpoint, but not catch all of these casual situations in the country that use seller financing in an appropriate way?

Mr. **PEARLMAN**. Mr. Dorgan, we have all spent a lot of time trying to figure out how we can deal with the problems that are sought to be dealt with by the imputed discount issue rules. They were not new in 1984, they have been around for a number of years, and a lot of people have given a lot of thought to that issue.

What you view or I view as abusive, and what kind of rule do we design as we would agree is the transaction that we really don't care about? What kind of transaction really carries with it a little more consideration, in which tax considerations are—I think it does raise philosophical issues. My philosophy is, again, it comes with a preference, and that is I am quite prepared to take small transactions and carve them out of these rules.

And we proposed that in our original budget proposal sent to the Congress by the President. There were small transactions rules. The exemptions weren't big enough, but from the very beginning we carved transactions out of these regulations.

Once you get beyond that, whatever the committee says, whatever ultimately the Congress enacts, the role of the tax system is to accurately measure the taxable income as the parties categorize the transaction. So that the tough issue, in my opinion, is how do we articulate the kind of transaction where we say we really don't care. And my own judgment is that a small transaction does have that, and we are headed down the right track. And once we get there we should say that the larger transaction is—we assume the people do know what the tax consequences are, and——

Mr. **DORGAN**. My concern again is that I understand if someone wants to convey property on the seller financing basis at a 1 percent interest rate and convert that into the value, and that has been done, and probably will be done again, and I don't countenance that, but again, for the kind of seller financing that I have participated in and watched, it is a paradox for the Government to be suggesting a policy that says your interest rates need to be higher, ladies and gentlemen. That is kind of where we have come with imputed interest, and especially as this area relates to——

Mr. **PEARLMAN**. I don't know whether you were here when Mr. Archer and I were talking. I just don't agree that whatever our guideline is, whether it is applicable Federal rate or something else, really mandates—what we are assuming is that when we set a rate it is above market rates, and not below market rates. We are not mandating a market rate. All we are saying is if the market does operate in a certain interest area, then we expect you, for tax purposes—we don't care what you do in your document, but we expect you, for tax purposes, to reflect that same kind of interest rate in reporting your taxable income.

I would hope that Congress would never mandate economic interest rates. I don't believe they do today.

Mr. **Dorgan**. One final question. Mr. Pearlman, do we have the best information Treasury has about the practices that you think are abusive in this area?

Mr. **Pearlman**. I think we provided the staff a good deal of material, and I presume it is still there.

Mr. **Dorgan**. I suspect that there are some out there who would want to use this to manipulate it for their own good, but I don't want to destroy seller financing in this country generally in order to catch a few abusive situations.

Can you see if Treasury has furnished us with that information?

Mr. **Pearlman**. Certainly. We will provide you with information we have.

Mr. **Gibbons**. Mr. Daub.

Mr. **Daub**. Mr. Secretary, I appreciate your being here. I am looking at my farmers who can get a 5¼-percent FHA operating loan, although the money is scarcer than I would like to have it, and I understand in my State we can't have a legal transaction without a 4-percent interest rate. We have established that by law. And I agree that land should be taxed, and I also agree there are abuses in this specific area.

It is my understanding that the principal policy concern which necessitates the imputed interest rules is that sellers may characterize an additional amount of their sales price as capital gain rather than ordinary income in the form of interest.

Is this correct?

Mr. **Pearlman**. And that the buyer will take the overstatement and basis in the same amount.

Mr. **Daub**. Is it not true that the Treasury tax reform proposal would eliminate the distinction between capital gains rates and ordinary income tax rates?

Mr. **Pearlman**. Yes.

Mr. **Daub**. Then are not the positions inconsistent? Would we not be irresponsible to pass sweeping legislation in this area until the capital gains problem is resolved in the committee?

Mr. **Pearlman**. No; I think that is a problem, but I think the serious problem is the basis overstatement of the ability to convert interest expense into a depreciable basis. And that issue is going to be with us no matter what happens in fundamental tax reform.

Mr. **Daub**. I would like to make the point that I am on record by what I just said in supporting the maintenance of the lower capital gains rate and in what we might call on Treasury to do. However, if capital gains should be eliminated, we should revisit the imputed interest rates again as well.

I have one last question for you. You raised it right at the tail-end of your testimony, and maybe Mr. Matsui might be interested in this as well. In the case of wrap-around financing, I understand the calculation process proposed by Mr. Matsui and others whereby the additional discount and imputed interest rules would be exclusive of any underlying debt.

Understanding the calculation and understanding its effect are two different things. For my information, could you explain to me precisely what the advantage of this provision is vis-a-vis simply applying the 9 percent test rate to the debt obligation between the seller and the buyer.

Mr. **Pearlman**. The wrap-around—well, let me start with debt assumptions. Start with that and then talk about wrap-around.

Debt assumption, in our tax system there is an additional consideration and sale, and, therefore, when a person takes property and assumes the debt, he gets the tax basis. Equal not only to whatever his financing arrangement is between the buyer and the seller, but he takes as part of his adjusted tax basis the assumed debt, so the problem of basis overstatement that we talked about a moment ago is exactly the same in debt assumption transactions as if the financing was eliminated from the transaction.

Now, what we have suggested is let's try and design a rule that will permit debt assumptions without producing any harsher restrictions than we need to preclude those problems, and the problem really has to do with depreciable property since there is overstatement. And that is why in our statement we think we have fashioned an antiabuse rule which says let debt assumptions proceed, let's not catch them by these rules, except where there is abuse in relationship to depreciation.

The wrap-around issue, and using wrap-around obligations as a solution for the debt problem, is not as easy for me to articulate because I am not at all sure that I fully understand what the proponents of that solution mean. If what they mean is simply that to the extent that the debt stays in existence, I am not sure whether the proponents of that position would say, and make the person liable on the debt, leaving that issue aside for a moment, that that is viewed as debt assumption, and whatever the debt assumptions are they would apply wrap-around obligations. That is one possibility.

What concerns me is when people start talking about debt assumptions and obligations as trying to use what we are trying to do here, in this effort, and that is clean up problems with the imputed interest in the original issue discount rules to get around problems in the installment sales in which people had used wrap-around obligations to avoid proper recognition of income under the installment sales.

And what concerns me, and it is the reason that I made the final statement that I made, is that when I hear talk about using a wrap-around analysis to deal with the debt assumption problem here, I have the uncomfortable feeling that we are going to find ourselves doing something in the installment sale area that we might not want to do, and that perhaps the committee might not want to do, so I must confess to you that I am not fully conversant on what the people in favor of the wrap-around approach intend by that approach, and that is why we think we can deal with the debt assumption issue to everyone's satisfaction by designing, by crafting a rule that says just apply a harsh debt assumption rule where there is a tax avoidance problem.

Mr. DAUB. Thank you, Mr. Chairman.

Mr. GIBBONS. Thank you.

Mr. Campbell.

Mr. CAMPBELL. Thank you, Mr. Chairman.

Mr. Pearlman, you stated to Mr. Daub the problem was depreciable property in the wrap-around rule. Isn't that your problem overall, period?

Mr. PEARLMAN. It is not the only problem. I think there are three major problems that we identified. No. 1, you have got the conversion, ordinary income to capital gain on the seller's side, and No. 3, you have got the mismatch of interest income and interest expense; that is, the payer taking deductions today, if he is on the accrual method, and recipient of the interest only picking up the——

Mr. CAMPBELL. But the depreciable property is the contributing factor——

Mr. PEARLMAN. That is a major piece of the problem, no question about it.

Mr. CAMPBELL. Well, we have had a lot of questions about the loss of revenue, and I know you don't have it, but you can supply it for the record. I would like to know how much are we talking about between what we have done under stopgap, and if we let it expire. How much revenue are we really talking about? Do you have any estimates on that?

Mr. PEARLMAN. I don't have it, but I would be happy to supply it. What you are really asking is what if stopgap was in effect for a year, what would be the revenue cost?

Mr. CAMPBELL. You got it.

Mr. PEARLMAN. We would be happy to provide that.

Mr. CAMPBELL. There are some other assertions that you make in your testimony that bother me a little bit, and Mr. Dorgan spoke about it a moment ago, and that is seller financing. Your argument is that when we use that below market rates, that that is for the purpose of an abuse.

Now, you have in your testimony said that even if it is not a conscious decision that it works that way. I would ask you this question. In a time of high interest rates is it not true that we generally see in the marketplace a lowering of property prices in order to sell?

Mr. PEARLMAN. Absolutely, Mr. Campbell.

Mr. CAMPBELL. If, in fact, at a time of high interest rates, we have a lowering of property prices, trying to sell, is it not also true, and is it not reasonable to think that a seller financed below market interest rate is a marketing tool just like cutting the price of the property was during the time of high interest rates?

Mr. PEARLMAN. Absolutely. I agree completely with you, and I don't think there is any disagreement between us. And what we say is that the interest model has to be one, and we can debate what the right rate is.

As I said, my guess is—I am talking to Mr. Archer—we are talking about something is wrong with the 2 percent rate, and we don't agree. At the 12 percent rate, a rate below that, something is funny.

All that means is that the purchaser has agreed to pay the buyer less for his property.

Mr. **Campbell.** OK. Let's discount the big deals which run the low interest rate and high depreciation. Let's talk about the small- to medium-sized things where a seller has something to sell, be it a small business, be it a family farm, be it a residence, or whatever it happens to be. They have something to market, they are trying to market it, and the interest rates are high, and the only chance they have is to go under the market. Why? Because they have to have a buyer that can pay whatever the rates of payment happen to be. That is a key consideration in many purchases. What is the cash flow? How can you pay those payments?

Now, if we impose upon that small business, that farm, that family, an imputed rate that takes away that tool, are we not stifling economic activity at the same time?

Mr. **Pearlman.** I have just taken it as a given, and sought not to dispute the statements that have been made by the industry that that will have a stifling effect on transactions. And I would simply respond to that by saying that that is why we should create a small transaction exemption. I think it is better, and I think it is more honest. And it will be better in terms of drafting a proposal, to admit that that is what we are doing.

We are saying that there are certain kinds of transactions in this country that we are prepared to see go forward, even though we recognize that the interest rate being charged is something that is not at arm's length.

Mr. **Campbell.** Let me ask one final question on that. Earlier you said you thought it ought to be a kind of a generic rule, instead of a housing exclusion, this, that and the other, that would cover a small business transaction, a large farm transaction, things like that. We are at $2 million. If you are going to make it a general rule that is going to apply to all of these people, what is a reasonable level? We have $2 million on that. Some people, especially in the sale of the small business, said that that doesn't cover it, you can't do it.

We have a proposal, under Mr. Matsui's, at the $4 million level. We have a repeal by Mr. Archer. If you have conceded that we need to have an exclusion, which you have, then the question is where do we have a general rule exclusion if that is what you want to see, that will cover those businesses and farms and the housing, if they are going to get caught in there, too? How high is it? Is it $4 million?

Mr. **Pearlman.** My prediction, and it is uninformed at that point, if we set a generic rule of $4 million, that you are going to create major tax shelter opportunities in this country, and I find that very disturbing.

Mr. **Campbell.** Where do you not create them?

Mr. **Pearlman.** I think you create them at every level.

Mr. **Campbell.** Then should we take care of those who are not trying to——

Mr. PEARLMAN. I believe that when someone is talking about $1 million of debt for a $2 million transaction, that is a pretty large transaction. When you go above those, we don't have to be talking about abuse, but when someone sells a business for $4 million, they understand what the tax consequences are. They understand what the economics are. Those transactions are not done sitting on a park bench. Those people are getting advice. I don't see any reason why we have to carve out safe harbor rates for transactions at those levels, and my judgment is that I would set the $2 million at the transaction side, and I don't see any sense in taking a $10 million transaction, and you get some kind of favored treatment on the debt——

Mr. CAMPBELL. Would you index it?

Mr. PEARLMAN. I don't think that is terribly critical.

Mr. GIBBONS. Mr. Gregg.

Mr. GREGG. Yes. I was wondering, Mr. Secretary, following your logic there, and I guess a $2 million threshold, it doesn't really matter, if your concern is overstatement of basis for depreciation purposes, why should we apply this rule at all to residences?

Mr. PEARLMAN. Well, again, that is not our only concern. We have got three issues, and depending on how you craft that $2 million exception, overstatement of basis is one of the issues, and one is the mismatch of interest expense, and the third is conversion of capital gain to ordinary income. And it seems to me that we have to look at all of them.

And depending on how you craft the $2 million exemption, for example, you follow Mr. Matsui's suggestion of using a cash matching rule on method accounting, although I have suggested that that may create some problems, that takes some pressure off part of the concerns, and forces you to focus on the others, And it seems to me that you got to look at all three.

Mr. GREGG. Well, I understood when Mr. Daub was asking you about the question of overstatement, you were saying that overstatement of basis was your primary concern. That one doesn't seem to apply to residents at all. Clearly you have got very little problem of residences on cash deferral issues, because almost everyone who buys a residence is going to be on a cash basis, and that eliminates two of them.

And the third item, if you look at your Treasury I proposal, you are consistent. So it seems to me on residence you don't have much of a case.

Mr. PEARLMAN. That point was made before by Mr. Daub about Treasury I, and it was indirectly made in connection with the auto sale. I can assure you that if there is no difference between ordinary income and interest income, people are not going to be complaining about imputed interest.

The reason the automobile dealer doesn't worry about whether he offers 8.8 percent financing is because he is going to pay ordinary income on the income from that car. Likewise, if ultimately, if Congress refuses to repeal a preferential rate for capital gains, and the seller is going to have ordinary income, the Government isn't going to care whether it is interest income or income gained from the sale of the property, but I think realistically we have to look at the rules on the current law. If Congress changes those rules, and there is no capital gains rule, obviously, the pressure is removed to some extent.

Mr. **GIBBONS**. Are there any other members who wish to ask questions of Mr. Pearlman now?

Mr. Pearlman, what is the imputed interest rate today? What is it today? I really just ask you that question. If you can't keep track of it, how in the hell do you expect——

Mr. **PEARLMAN**. Mr. Chairman, I don't try to keep them in my head.

Mr. **GIBBONS**. I really asked you that question because I was hoping you didn't know the answer. And I just kind of feel like we ought to prepare the law so the people know what the heck they are doing.

If the man at the Treasury who is writing these regulations doesn't know what he is doing, how can you expect anybody else to know?

Mr. **PEARLMAN**. That rate is changed monthly. I don't think it is fair——

Mr. **GIBBONS**. Where do I go to find out what it is?

Mr. **PEARLMAN**. The Service publishes that rate every month.

Mr. **GIBBONS**. How much does it cost to subscribe to your——

Mr. **PEARLMAN**. We will do it free for you, Mr. Chairman.

Mr. **GIBBONS**. How about all the rest of the American taxpayers?

Mr. **PEARLMAN**. We have talked to major financial publications in the country, their chairmen, and you will find they are also going to publish those rates, so they should be available by opening any of the major newspapers on a daily basis.

Mr. **GIBBONS**. Can you tell me where I can find it in the Wall Street Journal? I don't have time to look through all the pages in that Journal every day. I try to keep reasonably informed about what we are doing, and just try to be practical.

Where do I find out what the rate is? I have got to call you up and get a rate from you?

Mr. **PEARLMAN**. Mr. Chairman, that rate is public information, and I think you will find that people, if I were out there practicing law today, I would know that rate. And my guess is that there are people who are dealing with real estate transactions who know where to find that rate. I could find that rate if I was sitting in my office for 2 minutes.

Mr. **GIBBONS**. Thank you very much.

Go right ahead, Mr. AuCoin.

STATEMENT OF HON. LES AuCOIN, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF OREGON

Mr. **AUCOIN**. Thank you, Mr. Chairman, and members of the committee. I appreciate the opportunity to appear. I have a full statement, Mr. Chairman, I would like to please submit for the record and give you a synopsis of that statement, if I may.

Mr. **GIBBONS**. Certainly. Your entire statement will appear in the record.

Mr. **AUCOIN**. I want to say that I appreciate the thorough consideration that the committee is giving to this issue, and I want to convey my concerns about imputed interest changes. As you know, there is little time remaining for Congress to act before the damaging provisions passed last summer become fully effective.

The stopgap rules approved last year will expire, as the committee knows, on May 1. If we let the clock run out, the ability of American to use lower rate seller financing to cope with the higher interest rates will be seriously impaired, with painful consequences.

Housing experts warn that it could cost us 120,000 jobs and $6 billion in lost GNP. Mr. Chairman, in Oregon we have been hard hit by high interest rates. We know what it means when we can't buy homes, or the lumber that goes into those homes. In fact, many people are waiting for economic recovery to pay them a visit. Double-digit unemployment is commonplace in the State of Oregon.

During these difficult times owner-financed sales have been a source of strength for the housing and real estate industries. Homes and other properties have continued to be bought and sold, because sellers are willing to offer an interest rate below the rate of traditional financing. As things stand now, we are simply holding a knife to the throat of the housing industry.

The new rules are overly complex, and if implemented would virtually destroy an important source for affordable homes for buyers of all kinds, including family farms, multistructures, and small businesses.

Industry sources estimate that in 1982 when interest rates skyrocketed, more than one-third of all home sales involved seller financing. If we make it virtually impossible for sellers and buyers to negotiate their own affordable credit terms, Mr. Chairman, we lose a valuable private sector hedge against high interest rates.

Furthermore, the present situation creates confusion and uncertainty in the marketplace. At a time when the market is already unstable because of concern about interest rates and the Federal deficit, we need to establish some permanent and fair rules so people can carry on business and make sound long-term investment decisions. Right now we have neither.

The temporary rules provide only temporary relief. If we allow the deficit reduction rates to take effect, the smaller seller would have to pay at least 13.49 percent to avoid the adverse tax consequences. Interest would be imputed at a 14.75-percent rate, and as the last recession clearly demonstrated, when mortgage rates head toward 14 percent, the housing industry virtually shuts down.

For all of these reasons, Mr. Chairman, I join my colleague, Congressman Archer, in the bipartisan effort to repeal the new interest rate provisions.

I understand my friend from California, Congressman Matsui, has recently introduced legislation designed to correct the most onerous effects of the new rules. And I would hope that at the very least we can reach a simple, realistic, effective solution that all parties can agree with.

I understand the need to address the deficit and to stem the revenue loss. However, I do not believe the Internal Revenue Service should be forcing people to charge higher interest than they wish to charge in the name of reducing the deficit.

I also understand the need to address some abuses in this area. However, if the current rules are left unchanged, too many innocent people will be penalized, so I hope the committee will take all the concerns, the economic concerns, the adverse impacts into consideration and act to protect legitimate owner-financed sales before very harmful effects are felt. And they will be felt. There is no question in my judgment about that fact.

Let's not hurt homeowners, homebuyers, or the housing industry, which has contributed so much to economic recovery. I think it is time for corrective action to keep seller financing viable.

I thank you for the time you have given me, Mr. Chairman, to submit these views and the opportunity to submit my full statement for the record.

[The prepared statement follows:]

STATEMENT OF HON. LES AUCOIN, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF OREGON

Mr. Chairman, thank you for giving me the opportunity to appear here today to testify concerning the imputed interest provisions contained in the Deficit Reduction Act of 1984.

I appreciate the thorough consideration you and your committee are giving to this important issue and want to convey to you my concerns about the imputed interest changes.

As you know, there is little time remaining for Congress to act before the damaging provisions passed last summer become fully effective. The stopgap rules which were approved last October will expire July 1.

If we let the clock run out, the ability of Americans to use lower-rate seller-financing to cope with higher interest rates will be seriously impaired, with painful economic consequences: Housing experts warn that it could cost us 120,000 jobs and $6 billion in lost GNP.

Mr. Chairman, my state of Oregon has been particularly hard hit by high interest rates. Oregonians know what it means when people cannot afford to buy homes or the lumber that goes into construction. In fact, many areas of the state are still waiting for economic recovery to pay them a visit. Double digit unemployment is commonplace.

The high interest rates that have brought many mills to a standstill have also made affordable mortgages scarce. During these difficult times owner-financed sales have been a source of strength for the housing and real estate industries. Homes and other properties have continued to be bought and sold because sellers are willing to offer an interest rate below the rate of traditional financing.

As things stand now, we're simply holding a knife to the throat of the housing industry.

Home owners, home builders and realtors in my state of Oregon have told me that the new rules are overly complex and if implemented, would virtually destroy an important source of affordable credit for buyers of homes of all kinds, including family farms, multifamily and commercial structures and small businesses.

Let me read you some of their comments:

"We are trying to keep interest rates down and this law adds in keeping them high. It will also depress a real estate market here that has been depressed for the last three years."

"In Oregon, the only method of financing land sales is owner financing. Under the [new rules] a 10 year contract would have to carry 13.9% monthly compounded interest or the IRS would impute 15%."

"The ability of sellers to offer buyers below market interest rates is the only way sellers can move properties at a time of high interest rates. The complex rules by which government would fix the price of home financing by sellers would shut down seller financing."

Industry sources estimate that in 1982, when interest rates skyrocketed to 18%-20%, more than one-third of all home sales involved seller financing. If we make it virtually impossible for sellers and buyers to negotiate their own affordable credit terms, we lose a valuable private sector hedge against high interest rates.

Furthermore, the present situation creates confusion and uncertainty in the marketplace. At a time when the market is already unstable because of concern about interest rates and the Federal deficit, we need to establish some permanent and fair rules so people can carry on business and make sound investment decisions.

Right now, we have neither. The temporary rules only provide temporary relief. If we do not achieve a workable solution, most seller-financed sales will have to carry rates equal to 110% of the applicable Federal rate. If a lower rate is charged, the seller will be taxed as if he collected interest equal to 120% of the applicable Federal rate. Only sellers of principal residences priced at $250,000 or less and farms priced at $1 million or less could continue to charge 9% or face a 10% imputed interest rate.

In plain English and in today's market, a seller would have to charge close to 13.5% to avoid the adverse tax consequences of the new law. Should an owner-financed transaction fail to carry an interest rate of at least this amount, interest would be imputed at a rate of 14.75%. And, as the last recession clearly demonstrated, when mortgage rates head toward 14%, the housing industry shuts down.

For all these reasons I joined my colleague, Congressman Archer, in a bipartisan effort to repeal the new interest rate provisions. I understand that Congressman Matsui has recently introduced legislation designed to correct the most onerous effects of the new rules. I would hope that at the very least we can reach a simple, realistic, but effective solution that all parties concerned can live with.

I understand the need to address the deficit and to stem revenue loss. However, I do not believe that the Internal Revenue Service should be forcing people to charge higher interest than they wish to charge in the name of reducing the deficit.

I also understand the need to address abuses in this area. However, I believe that the new rules go far beyond their stated intent to end abuses. If left unchanged, too many innocent people will be penalized.

I hope the committee will take these concerns into consideration and act to protect legitimate owner-financed sales before the harmful effects are felt. Let's not hurt home owners, home buyers and the housing industry which has contributed so much to economic recovery. Let's take corrective action and keep seller-financing viable.

Thank you for allowing me to present my views. I would be happy to answer any questions you may have.

Mr. GIBBONS. I want to thank you for the statement.

Could you tell us what the imputed interest rate is today? They are having a hard time figuring it out. You gave it to us in your statement, and I want Treasury to understand what it is, in case anybody asks them.

Mr. GARLACH. Mr. Chairman, if I may——

Mr. GIBBONS. Who is this?

Mr. GARLACH. I am David Garlach from the Treasury Department.

Mr. GIBBONS. We are having a little fun with the Treasury here now. You do not mind.

Mr. GARLACH. We propose in our testimony to eliminate the distinction between the imputed and the testing rate and so I think it is a bit unfair to criticize the Treasury Department for the 14.75 percent rate. I think the more relevant comparison is the testing rate which is I guess around 13½ percent.

Mr. GIBBONS. We appreciate the Treasury adding that in there, and I hope they will come up with a proposal. You know they came up with this beast we have got right now and I hope they will come up with a proposal that most people can live with. That is what we are asking them to do.

Mr. GARLACH. I think we ought to keep trying to get it right, Mr. Chairman.

Mr. GIBBONS. Well, let us not hope; it cannot be that long.

Thank you very much.

Let us see, are there other questions for Mr. AuCoin?

Mr. Pease.

Mr. PEASE. Thank you, Mr. Chairman.

Mr. AuCoin, we appreciate your testimony. I ask this question not in a hostile or challenging way at all, but out of genuine bewilderment, I guess. I guess what we are talking about is transactions arranged between two private individuals in most cases. I am talking about a home sale. So we have got, say, a house that is not only worth $100,000, the amount of money that the seller gets from the buyer over a period of time where you have got private financing arranged, is a function of two different figures: First, the selling price and, second, the interest rate. Thus, if the selling price is established at $100,000, and the interest rate is 10 percent, which would have been in pattern 4, the seller gets $10,000 a year for however many years the two agree to.

I guess what I have never been able to understand, and I am still struggling to understand it, is why in this arrangement where two individuals are talking to each other, if the interest rate has to be 13 percent, the seller could not reduce the selling price below $100,000, say, to $80,000, so that the interest payment turns out to be $10,000 a year, the same as it would have been with $100,000 at 10 percent. In other words, you can manipulate those two figures so that the seller gets the same amount of money and the buyer pays the same amount of money. The only difference is the stated interest rate and the stated value of the property.

As I say, I do not ask that in a hostile way. It just seems sensible that two people could manipulate that figure very easily. Apparently, there is something there that I just do not see.

Mr. **AuCoin**. There may be other witnesses who can answer the question better than I. I just have the philosophical disagreement with an attempt by the Government to set a floor, establish a floor on interest rates. And I think that would be the effect of the proposal if it goes forward.

There may be other witnesses who can answer your question better than I could.

Mr. **Pease**. Thank you.

Mr. **Gibbons**. Mr. Campbell.

Mr. **Campbell**. Mr. Chairman, let me, before I ask you a question, take that same scenario and you are selling me a house for $100,000, but you cut the house to $80,000 and I pay you 13½ percent interest. That is fine, assuming the transaction goes to its full length. We have, you know, conducted a sham. I am paying 13½ percent, but you have cut the rate to $80,000 below the market, and I am going out as soon as I can at a lesser rate. What is going to happen is I am going to pay that mortgage off if I do not have a penalty clause in it. You are going to come out short and I am going to come out on top of the deal. That is what is going to happen, Mr. Pease.

Mr. **Pease**. Would the gentleman yield?

Mr. **Campbell**. Yes. I wanted to ask him a question. Sure.

Mr. **Pease**. If the gentleman would yield, I would assume that the buyer and seller would look into that contingency and take account of it and specify that over the life of the mortgage, a total of *x* dollars would have to be paid even if the payments were prepaid.

Mr. **Campbell**. Well, unfortunately, I do not believe that you will find that in all instruments. I think that you would have to have a special provision in that and in many of them there are no prepayment penalties. And in many of your commercial transactions there are no prepayment penalties. Some of them are, obviously. But, you know, it would not be something that you could assume would be a part of it.

Mr. **Pease**. If the gentleman would yield further.

Mr. **Campbell**. I would be happy to.

Mr. **Pease**. I assume that it is not in all of them currently, but if 13 percent or 13½ percent has to be charged, would not a prudent lawyer for a buyer and a seller make that suggestion so they would be covered?

Mr. **Campbell**. I guess the difference between my position on it and someone else's would be that I would be the first to assume that the people were entering into a transaction that was above board and not for devious purposes. I think that when we assume that when people from the beginning are entering into buying or selling for devious purposes then, yes, I would presume they would have a good lawyer to do that.

But I would like to ask Mr. AuCoin a question. He is very knowledgeable in the housing industry and other areas, I asked the Treasury awhile ago when Mr. Pearlman was testifying about an appropriate level of exclusion. We discussed—and I do not know whether you had come into the room then or not—the $2 million level or a $4 million level, looking to include small businesses, farms, housing, all of these things in the exclusion.

I then asked him and he seemed to think that $2 million was more appropriate. Mr. Matsui and some of us think a higher level may be more appropriate. But I also asked him a question if he thought that we should index that, if we did establish it, and he, if I am not mistaken, said that he did not think indexing was important.

Would you think that if we did establish a level that we should index that to inflation so that we would have a true level?

Mr. **AuCoin**. It would not be a true level unless it were indexed. It would not be a true level over time. You would have a gradual decreasing level. If we make the policy determination that it should be set at some dollar amount, then in order to protect that policy decision, you would have to, I think, index it in order to preserve that policy decision in the future.

Mr. **Campbell**. I really appreciate the answer because that is the position I take. My concern has been that Treasury is proposing to index interest, index basis, and yet it does not seem to be necessarily concerned about indexing this level that we are going to try to establish, if we try to establish it. I am delighted to hear your answer on that.

Have you looked at a level that you think would be appropriate for an exclusion?

Mr. **AuCoin**. I have not at this point, Mr. Campbell. If you would like that for your own further consideration, I would be happy to reflect on it further. I think it is the principle that you expressed that I support. A precise level is one that I would be happy to provide for you at a later time.

[The following was subsequently received for the record:]

Ideally, I would prefer to see the new imputed interest rules repealed altogether. However, as I said before, I understand the need to address abuses in this area. It's one thing to curb unintended tax benefits, but it's quite another to penalize legitimate transactions between people trying to sell their home, their small business or farm. For my part, I would support a minimum level in the range of $2 billion–$4 billion. I think we need to reach an agreement on a level which can adequately cover small businesses and farms as well as residences. And, it must be fashioned in a way that is easy to understand.

Mr. **Campbell.** I would be interested in having it. Thank you very much for your testimony.

Mr. **AuCoin.** I appreciate your line of questions.

Mr. **Archer.** Mr. Chairman?

Mr. **Gibbons.** Yes, Mr. Archer.

Mr. **Archer.** Mr. AuCoin, I thank you very much for coming before the committee today.

Mr. **AuCoin.** I appreciate the gentleman's leadership on this issue.

Mr. **Archer.** Well, I appreciate your joining with me in cosponsoring, on a bipartisan basis a bill to repeal these odious provisions that were put in the law in 1984. We have 188 cosponsors as of today on our bill for repeal. The thing people tend to forget is that there are already provisions, or were already provisions in the law in 1983 and prior to the 1984 change which gave an opportunity to prevent abuses.

The Treasury had set the rate at 9 percent. They had, under the law, the ability to set the rate any way they wanted and, for some reason or another, that was not good enough. They wanted to come down here and get the Congress to statutorily enact some sort of a level which they basically had the power to do. Now, if there are abuses, it seems to me that we could compromise with them under the umbrella of our legislation by permitting the compounding of whatever rate they set, which they said was one of the problems. We could get at some of the major abuses without all of the complexities that we saw in 1984, and which would continue to a great degree in what they say they are willing to do today.

I appreciate the gentleman's testimony and I thank him for what I think is a very clear presentation of what the realities are.

Mr. **AuCoin.** Well, as I said, I think the gentleman from Texas has exercised excellent leadership as has my friend from California, Mr. Matsui. I am happy to join both of those gentlemen in a bipartisan effort to correct something that really is a very, very sad mistake.

Mr. Chairman, do you have further questions for me?

Mr. **Gibbons.** No, thank you, Mr. AuCoin. I appreciate your coming very much. It was good testimony.

We have got a panel of witnesses next. The National Association of Realtors; the National Multi Housing Council; the National Association of Homebuilders; and the National Apartment Association. Mr. Wallace, Mr. Driesler, Mr. Smith and Mr. Sherman.

Mr. Wallace, we would be glad to hear from you first.

STATEMENT OF CLARK E. WALLACE, PRESIDENT-ELECT, NATIONAL ASSOCIATION OF REALTORS

Mr. **Wallace.** Mr. Chairman, members of the committee, I am Clark Wallace, president-elect of the National Association of Realtors, a trade association representing over 670,000 individuals engaged in all facets of the real estate industry in every city, village, and hamlet in America. We appreciate the effort shown by the members of this committee and others in Congress in recognizing that last year seller financing provisions were quite simply overkill. Clearly, a shotgun was used when a pistol would have been more appropriate.

Our concern now is that the stopgap legislation which temporarily improved the situation expires June 30 of this year. Therefore, now is the time for Congress to put this issue to bed once and for all.

We oppose the 1984 imputed interest rule changes because, first, the interest rates mandated therein would eliminate the historic ability of seller financing to pick up the slack when high institutional lending rates bring the real estate market to its knees.

Second, the 1984 rules are entirely too complex.

Third, many unanswered questions have surfaced because the way the rules were written, and, we fear many more wait yet to be discovered.

Fourth, the 1984 changes literally force sellers to use the accrual accounting method.

Overall, these rules are truly mind-boggling for unsophisticated buyers and sellers and must be addressed by this committee. We are not here today to ask that last year's rules be totally repealed, although we would not object to that. However, we are here today because we believe that failure to act now would mean disaster ahead for seller financing of real estate and thus cripple a substantial portion of the economy at the worst possible time.

Let us look, for example, at what would have occurred in 1982 had the 1984 rules been in force. In 1982, the average over-the-counter long-term interest rate for real estate was 13¼ percent, while the average seller financed rate was only 11.8 percent. This affordable seller financing interest rate accounted for 34 percent in 1982, or approximately 800,000 home sales nationwide, and 41 percent of all farm sales. Seller financing was equally important in 1982 for commercial office buildings and multifamily structures. Had the 1984 rules been in effect in 1982, sellers would have been required to charge 14.58 percent or have it imputed at 15.9 percent.

Buyers, which history has shown to be unable to afford institutional lending rates during this 1982 time period would have been unable to afford seller financing as well under the 1984 rules. In effect, a much more severe market collapse would have occurred.

Clearly, this potential future disaster must be corrected, and we are here to tell you that we strongly support as a solution to this dilemma House bill 2069, introduced by Representative Bob Matsui and other members of this committee.

Here is why we support the Matsui Bill.

First, the bill would provide interest rates of 9 percent or 80 percent of the AFR, whichever is lower, for seller financed amounts up to a $4 million threshhold.

Second, interest rates on seller financed amounts above $4 million would have to be at least equal to 80 percent of the AFR.

Third, the bill would eliminate the ability of buyers and sellers to mismatch interest income and deductions.

And, finally, Mr. Matsui's bill would exempt loan assumptions from the rules and only apply the rules to the actual interest return obtained from the seller's equity in wraparound transactions.

The Matsui bill addresses Treasury's primary concern with mismatched interest income by proposing a more livable real world solution than simply by forcing everybody into an accrual accounting method. The key, we believe, is in establishing a reasonable interest rate in otherwise harsh times. The Matsui bill does this. The essence of our message is, therefore, allow interest rates to be affordable, make the rules simple, and do it before June 30.

Thank you very much.

[The prepared statement follows:]

STATEMENT OF CLARK E. WALLACE, PRESIDENT-ELECT, NATIONAL ASSOCIATION OF REALTORS

I am Clark E. Wallace, President Elect of the National Association of Realtors. The National Association of Realtors represents over 670,000 individuals engaged in all facets of the real estate industry. We commend the Chairman for holding these hearings and for providing an opportunity to discuss permanent imputed interest/seller financing tax rules.

Mr. Chairman, as you know, the imputed interest provisions contained in the Deficit Reduction Act of 1984 have been the subject of intense controversy since their enactment. The reasons are simple.

The Act proposed to dramatically increase the level of interest required when sellers finance all or any part of the purchase price in a real estate transaction.

The new required interest rate was linked to a complex indexing formula which set rates well above traditional seller financing interest rates thereby destroying the historical ability of seller financing to counterbalance unaffordable third party lending rates. Specifically, prior to the Act, sellers financing a property sale were required to charge 9% interest. The Act increased this by requiring sellers to charge 110% of the rate paid on government obligations of similar maturity (the so-called "applicable federal rate").

The proposed increase in required interest rates was so dramatic that many other unanswered questions surfaced concerning, for example, the proper interest rate tax rules applicable to loan assumptions and wraparound financing transactions.

The act extended the "original issue discount" rules for the first time to real estate transactions. These rules are designed to eliminate the ability of buyers and sellers to mismatch interest income and deduction by, in effect, requiring accrual accounting by sellers. Thus a "cash basis" seller may be forced to pay immediate tax on unreceived interest income. The amount of forced interest income is determined again by reference to the applicable federal rate. While sounding relatively simple these rules are truly mind-boggling for unsophisticated buyers and sellers.

Mr. Chairman, the National Association of Realtors is not here today to ask that the clock be totally turned back to the pre-Deficit Reduction Act seller financing rules. We believe that the potentially abusive interest income and deduction mismatch which brought about these rules can and should be legislatively addressed without unnecessarily paralyzing all seller financed real estate transactions. However, it is also our belief that total implementation of the Deficit Reduction Act would substantially disrupt, and in many cases entirely stop, many economically motivated seller-financed real estate transactions.

We congratulate members of this Committee and others in Congress for recognizing the overzealous nature of last year's seller financing provisions and for providing helpful legislation to mitigate the impact which would have resulted to the real estate industry, and to the overall economy, had these rules been allowed to totally take effect as originally scheduled January 1, 1985. However, the stopgap legislation enacted late last year which maintained reasonable interest rate rules for many seller financed real estate transactions expire July 1, 1985 and we urge Congress to promptly address this issue.

If Congress does not act by July 1, then all seller financed sales of multifamily and commercial properties plus sales of principal residences costing more than $250,000 and farms costing more than $1 million will be required to charge interest equal to 110% of the applicable federal borrowing rate. This means that a seller of real property taking back all or any part of the financing for 10 years must charge the buyer 110% of the rate which the Federal government pays on 10 year obligations. Even with the recent decline in interest rates, this requires sellers to charge 13.06% interest. Last summer the long term federal borrowing rate itself was 13%—meaning an owner would have been required to charge a buyer at least 14.3% interest.

Mandated interest rates at this level would eliminate the historic ability of seller financing to counteract unaffordable institutional lending rates. In fact, in some situations seller financing rates might exceed institutional mortgage rates. Our data, summarized in an appendix to this testimony, shows that about $30 billion of rental residential, commercial and industrial sales would be in jeopardy annually under these rules. This loss of sales would reduce annual Gross National Product by up to $6 billion which represents about 120,000 fewer full time jobs and about $2 billion of lost federal, state and local tax revenues.

While many of the assumptions put forward to justify the Deficit Reduction Act rules may have some "intellectual" attractiveness, they have no attractiveness or justification to the real world of real estate finance. Consequently, these rules need to be permanently addressed before they become fully effective July 1, 1985.

RECOMMENDATION

The National Association of Realtors strongly supports the legislative solution to the imputed interest issue contained in H.R. 2069 introduced by Representative Bob Matsui and other Members of this Committee and S. 729 Introduced by Senator Dave Durenberger. This solution would ensure the continued availability of seller financing at reasonable interest rates, plus effectively prevent the potentially tax abusive mismatch of interest income and deduction.

H.R. 2069 and S. 729 would:

Allow the prior law interest rate requirement of 9%, or 80% of the "applicable federal rate", whichever is lower, for seller financed amounts of up to $4 million per transaction;

Require interest rates on seller financed amounts in excess of $4 million to be at least equal to 80% of the "applicable federal rate";

Eliminate the ability of buyers and sellers to mismatch interest income and deduction by extending the original issue discount rules to transactions over $4 million and by requiring uniform accounting methods for all smaller seller financed transactions, and;

Exempt loan assumptions from the rules because they have already met the adequate interest requirements when originally issued and, in wraparound financing transactions, apply the rules to the actual interest return obtained from the seller's equity.

DISCUSSION

For many years, the ability and willingness of owners to finance sales of residences, farms, multifamily dwellings and businesses at affordable interest rates has enabled people to continue to do business in spite of unaffordable rates charged by third party institutional lenders. This is especially true during high or rising interest rate periods. For example, during the high interest rate recession of 1982, 34 percent, or approximately 800,000 home sales involved seller financing and 41 percent of all farm sales involved seller financing at an average 11.8 percent interest rate. Seller financing was an equally important financing mechanism for commercial office buildings and multifamily structures.

Prior to the enactment of The Deficit Reduction Act, the law (Internal Revenue Code Section 483) required sellers financing a real estate transaction to charge interest at a rate of nine percent simple, or be taxed as if they were receiving 10 percent compound. These safe harbor and imputed interest rate levels were fixed and subject to change by Treasury Department Regulation.

The Deficit Reduction Act (originally to be effective January 1, 1985, but later partially delayed until July 1, 1985) requires that sellers financing real property sales charge interest at least equal to 110 percent of the interest rate on government obligations of comparable maturity (applicable federal rate). If interest is not charged at this level, then the Internal Revenue Service will impute interest to the transaction and tax the seller as if interest equal to 120 percent of the Federal rate were received. Even though interest rates have "declined" recently, the average interest rate on long term Federal securities today is 11.87 percent; therefore, sellers are being asked to charge at least 13.06 percent interest or be taxed as if receiving 14.24 percent interest.

Federally mandated interest rates at this level are clearly counterproductive to any effort to bring down interest rates and ensure continued economic recovery.

The current difference between long term mortgage interest rates and the underlying inflation rate remains at more than 9 percentage points—nearly triple the difference existing from 1950–1980. These high real interest rates are already harming the economy and mandating seller-financed rates at this level will unwisely exacerbate this problem.

Supporters of these new, higher safe harbor and imputed interest rate levels make a seriously erroneous assumption to justify The Deficit Reduction Act provisions. These few assume that all sellers who provide financing at rates below those offered by third party institutional lenders do so solely because of taxation concerns. Ths simply is not the case.

For example, in at least six states, Arkansas, Kentucky, Michigan, Minnesota, Mississippi and Washington, the interest rate mandated under The Deficit Reduction Act would have exceeded the legally allowable state interest rate for individual land sales contracts. Although the imputed interest rate rules are for federal tax purposes and do not technically violate the usury laws, the new rules could require a seller to pay taxes on interest he would not legally be allowed to charge. We believe this is a ridiculous position in which to place taxpayers.

Further, common business practicalities dictate financing terms agreeable to both buyer and seller—not just taxation concerns. Small commercial and industrial business owners need the flexibility to negotiate favorable financing terms especially during unstable economic periods. The Deficit Reduction Act rules provide no flexibility. Most of the small property owners we are familiar with are fighting for survival and not engaged in tax abuse.

A simple examination of the facts in 1982 relative to real estate finance will demonstrate the potential disaster which these new provisions invite. In 1982, the average long term Federal security rate was 13.25 percent and the average seller financed interest rate was 11.8 percent. Had the new rules been in effect in 1982, sellers would have been required to charge 14.58 percent interest (110 percent of long term Federal security rate) or interest would have been imputed and the seller would have been taxed at 15.9 percent (120 percent of the Federal rate). Buyers, which the market has shown to be unable to afford third party lending rates during this time period, would now have been unable to afford the alternative seller financed interest rate. In effect, a much more severe market collapse would have occurred.

Not only would the level of interest mandated under The Deficit Reduction Act for seller financed real estate transactions defeat the ability of sellers to counteract and help bring down high institutional interest rates but the rules also present the very real possibility that seller provided interest rates would exceed the mortgage interest rates offered by institutional third party lenders. Such a situation would have occurred in June 1984 and is demonstrated below:

TABLE II

Maturity	Yield on Treasury securities [1]	110 percent of T-securities	120 percent of T-securities	Mortgage interest rates [1]
1 year	12.1	13.3	14.5	13.0
3 years	13.2	14.5	15.8	14.2
5 years	13.5	14.9	16.2	14.8
10 years or more	13.6	15.0	16.3	14.8

[1] Average for June, 1984.

Source: National Association of Realtors.

Further, under the Act, sellers would be required to know what "applicable federal interest rate" is required. This "rate" did not exist prior to last year's tax bill and even though now applicable for some transactions, we have yet to see the rates published in the Wall Street Journal.

Clearly, if the imputed interest provisions contained in The Deficit Reduction Act of 1984 (IRC Section 1274 and Section 483 as modified by the Technical Corrections resolution) are allowed to become effective as scheduled July 1, 1985, then sellers financing sales of farms costing more than $1 million, small businesses, multifamily and commercial properties and "non principal" residential property could no longer negotiate their own affordable credit terms and would be required to state an interest rate equal to 110 percent of the comparable Federal securities rate. The counterbalance to high institutional lending rates would be destroyed and many, many real estate transactions simply would not be consumated.

SOLUTION

The National Association of Realtors does not favor the entry of the Federal government into freely negotiated sales contracts. The Federal government setting interest rates goes against the grain of a free enterprise system. It is bad economic policy. Lower interest seller loans are not only the key to the completion of many transactions, they act as a balance against high interest rates and help bring those rates down.

Sellers taking back financing should be able to charge interest rates lower than institutional lenders because, unlike institutional lenders, they do not have to compete for their capital in the lending marketplace and, therefore, sellers generally have a lower cost of money. A seller's money may have been earned in an earlier, less costly economic environment. In addition, a seller does not have the overhead costs that a lending institution does and a seller likely is willing to accept more risk, i.e., a lower interest rate, because he has a vested interest in selling the property. A seller's rationale for providing financing is completely different from that of a lending institution. An institutional lender earns its profit in lending money. A seller makes profit on property sales. For these reasons, the National Association of Realtors recommends that Congress act quickly and enact the following seller financing tax rules embodied in H.R. 2069 and S. 729.

1. Interest rates

The National Association of Realtors believes that a reasonable interest rate is the key to the imputed interest solution. Congress recognized in the recent Deficit Reduction Act that certain types of transactions (specifically sales of principal residences) should retain the imputed interest treatment of prior law. We believe that this concept should be maintained and extended to all amounts of seller financing below $4 million by requiring a test rate on these amounts equal to the lower of 9% or 80% of the applicable federal rate. For amounts of seller financing exceeding $4 million, we support an established test rate equal to 80% of the applicable federal rate.

These rules would allow sellers taking back relatively small amounts to maintain lower interest rates (9%) than sellers taking back larger amounts (over $4 million), on which interest at least equal to 80% of the federal rate must be charged. When interest rates are high, the 9% amount will maintain preferential treatment for sellers taking back smaller amounts of financing. Thus, unsophisticated transactions would face minimal disruption. When conventional interest rates are below 9%, the 80% option prevents these sellers from having to charge an interest rate greater than that required of sellers taking back large amounts of financing (over $4 million). It is our judgment that interest rates at these levels will preserve the ability of seller financing to counteract high conventional rates plus automatically move in relation to changing market rates—thus addressing a major concern about prior law articulated by the Treasury Department.

Recently, there has been discussion about using an index other than the applicable federal rate to determine the required interest rate for "large-scale" transactions (defined in the Matsui and Durenberger bills and supported by the National Association of Realtors as seller financing in excess of $4 million). The cost-of-funds index, which is based on the semi annual report of lending conditions that S&Ls submit to the FHLBB, has been the major subject of this discussion. This index represents the ratio of the actual interest cost of savings and borrowings during a six month period over the average savings plus borrowings based on seven month end figures.

The advantages of the cost-of-funds index include: (1) it is slow moving; (2) borrowers perceive it to be fair; (3) many lenders like it because it is easy to administer; and (4) it is relatively well-known to the real estate industry. The disadvantages to the cost-of-funds index include: (1) the index moves sluggishly which can be a disadvantage when rates are falling; (2) the index has historically never fallen significantly and is not expected to due to the decontrol of passbook and other savings rates; and (3) it does not present different rates for different loan maturities.

The following table demonstrates the historical spread between the cost-of-funds index and the applicable federal rate for varying maturities. You will note that the cost-of-funds index more closely tracks the 80% of the applicable federal rate figures than it does the 100% of the applicable federal rate figures.

INTEREST RATES, MONEY AND CAPITAL MARKETS

[Average, percent per annum]

	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985 [1]	AFR [2]
FSLIC cost of funds (COF) [3]	6.14	6.32	6.38	6.44	6.66	7.47	8.94	10.92	11.38	9.82	10.03	9.40	
Applicable Federal rates:													
AFR Short-term [4]	6.73	7.61	7.50	7.16	6.38	7.85	9.23	11.04	14.16	13.90	[3] 10.25	2.01	9.54
Spread v. COF	.59	1.29	1.12	.72	−.28	.38	.29	.12	2.78	4.08	.22	2.61	.14
AFR Mid-term [5]	6.71	7.55	7.77	7.62	6.91	8.00	9.05	10.96	13.76	13.94	[3] 11.25	12.95	11.00
Spread v. COF	.57	1.23	1.39	1.18	.25	.53	.11	.04	2.38	4.12	1.22	3.55	1.60
AFR Long-term [6]	6.62	7.59	8.02	7.94	7.46	8.20	8.99	10.88	13.25	13.72	[3] 11.56	13.01	11.40
Spread v. COF	.48	1.27	1.64	1.50	0.80	0.73	0.05	−0.04	1.87	3.90	1.53	3.61	2.00
80% AFR Short-term [4]	5.38	6.09	6.00	5.73	5.10	6.28	7.38	8.83	11.33	11.12	[3] 8.20	9.61	7.63
Mid-term [5]	5.37	6.04	6.22	6.10	5.53	6.40	7.24	8.77	11.01	11.15	[3] 9.00	10.36	8.80
Long-term [6]	5.30	6.07	6.42	6.35	5.97	6.56	7.19	8.70	10.60	10.98	[3] 9.25	10.41	9.12
110% AFR Short-term [4]	7.40	8.37	8.25	7.88	7.02	8.64	10.15	12.14	15.58	15.29	[3] 11.28	13.21	10.49
Mid-term [5]	7.38	8.30	8.55	8.38	7.60	8.80	9.96	12.06	15.14	15.33	[3] 12.38	14.24	12.10
Long-term [6]	7.28	8.35	8.82	8.72	8.21	9.02	9.89	11.97	14.58	15.09	[3] 12.72	14.31	12.54
Other rates:													
Federal funds, effective rate	10.50	5.82	5.04	5.54	7.93	11.19	13.36	16.38	12.26	9.09	10.23	8.58	
One-year Treasury bill	7.70	6.28	5.52	5.71	7.74	9.75	10.89	13.14	11.07	8.80	10.89	9.86	
Five-year Treasury	7.80	7.77	7.18	6.99	8.32	9.52	11.48	14.24	13.01	10.80	12.24	11.52	
Moody's corporate AAA bonds	8.57	8.83	8.43	8.02	8.73	9.63	11.94	14.17	13.79	12.04	12.71	12.56	
FNMA securities [7]	9.43	9.37	9.11	9.05	9.90	11.94	14.34	16.59	14.97	13.16	13.65	12.07	
FHLMC securities [8]	[9] 9.71	[9] 9.10	[9] 9.06	8.75	9.64	11.52	13.61	16.50	15.65	13.24	13.71	[10] 13.00	
Six-month negotiable CDs [7]	9.98	6.89	5.62	5.92	8.61	11.44	12.99	15.77	12.57	9.27	10.68	9.60	

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[1] As of April 2. 1985 (except as noted).
[2] AFRs in this column based on temporary regulations; where lower, they supersede statutorily calculated figures (as of April 2, 1985).
[3] Calculated as an average of actual semiannual figures.
[4] Approximate statutory calculation using quarterly figures of appropriate 3-year Treasury obligations (Constant Maturity Yield)
[5] Same as C using 5-year and 7-year Treasury obligations.
[6] Same as C using 10-year 20-year, and (where available) 30-year Treasury obligations.
[7] Calculated as an average of actual quarterly figures.
[8] Calculated as an average of weekly and daily average yields (except as noted).
[9] Calculated as an average net yield of whole loans.
[10] As of February 1985.

Source: Real Estate Finance Division, Apr. 11, 1985.

The applicable federal rate was the index chosen by Congress to apply to all "adequate" interest tax rules including real estate. We believe that 80% of this rate is needed by the industry as an alternative to unaffordable third party institutional lender rates. The cost-of-funds index, or some other index, may be seriously advanced by some as a substitute for the applicable federal rate and may be acceptable—but only so long as the resulting rate is comparable to 80% of the applicable federal rate. However, any attempt to impose the cost-of-funds index plus a certain amount of points would be completely unacceptable.

2. Accounting methods

The National Association of Realtors agrees with Treasury that the mismatching of reporting of interest income and deductions by a seller and a purchaser in a seller financed real estate transaction creates the potential for tax abuse. However, we disagree with the solution that Treasury recommended for the problem and which is ultimately included in the Deficit Reduction Act. Treasury convinced Congress in the 1984 Tax Reform Act that the mismatching of income issue was best remedied by extending the original issue discount (OID) rules to seller financed real estate transactions. The OID rules basically require the seller to account for the interest income on the accrued method of accounting. The rules require that the amount of accrued income be at least equal to 110% of the applicable federal rate.

The complexity created by the coupling of OID (accrual accounting) and imputed interest (110% of applicable federal rate) is mind-boggling. In a typical real estate transaction, the seller is concerned with the time value of his proceeds and liabilities. For example, to determine the attractions of an offer, a seller has to determine the net effect of having to recognize a certain amount of income in year one for tax purposes as opposed to receiving it years later. This net effect must be determined by taking into account a number of factors that affect the tax liability of a transaction including depreciation, capital gains and interest income. The OID provisions require the interest income be considered for tax purposes as having been received whether the buyer pays it or not and results in a recasting of depreciable basis and, obviously a reallocation of basis between land and the structure. Several respected economic analysts that we have contacted have found the OID provisions extremely difficult to understand and in many cases give different resulting offers to the same transaction. This complexity will discourage transactions and thus are undersirable for optimum economic well being.

The National Association of Realtors supports the provision in S. 729 and H.R. 2069 that exempts seller financed transactions below $4 million from the OID rules. These bills instead solve the mismatching of income and deductions problem by requiring that both the purchaser and seller use either the cash methods or the accrual method of accounting. The result—the potential abuse is stopped without the unnecessary and undesirable complexity.

The National Association of Realtors is willing to work with the Treasury Department and Congress to rectify any remaining problems created by these few instances where abuse can still occur despite the matching requiring (i.e., when one of the parties to the transaction is a tax-exempt or charitable organization.

3. Assumptions/wraparound loans

The National Association of Realtors does not believe that the imputed interest rules should apply to a transaction simply by reason of a loan assumption. The rationale beyond the exemption for loans assumed or taken subject to is that those lending transactions were originally contracted for under a different set of imputed interest rules and should not be forced to run the gauntlet of a new set of imputed interest rules and OID provisions that could force the parties to renegotiate the terms of the loan. Further, we do not oppose applying the rules to wraparound or other all inclusive debt instruments, but we suggest that the imputed interest rules should not be measured against the interest rate in the wrap note, but should be tested against the actual rate of return which the seller receives on the equity portion of the wrap note.

We believe this formula produces a balanced and sensible result in establishing the actual cost of funds and, hence, the true yield to the seller. These rules are illustrated in the following example.

Example: Real estate is sold for a total purchase price of $2.5 million. The purchaser makes a downpayment of $500,000 and issues a wraparound mortgage and note to the seller for the balance of $2 million. Interest accrues on the $2 million wraparound note at the rate of 10 percent per annum. In addition, the seller must make payments on an underlying obligation of $1 million at an annual rate of 8 percent interest. Since the seller receives from the purchaser $200,000 in interest per annum on the wraparound note and makes payments of $80,000 to the previous owner on the underlying obligation, the seller realizes a new yield of $120,000 annually from the wraparound note. This amount represents a return of 12 percent to the seller on his equity of $1,000,000, which equals the amount of the underlying obligation to the prior owner. In this example, the annual return to the seller on his equity is 12%, which would be applied in determining whether the test rate was met. In this example, the return of 12 percent would satisfy the test rate of 9%. Hence, the OID and imputed interest provisions would not apply to the transaction.

4. Capital loss situations

The National Association of Realtors believes that rules should be enacted to ensure that if a taxpayer would otherwise suffer a capital loss from a real estate investment, that loss should not be increased because of punitive imputed interest rules. We urge Congress to therefore treat all capital loss situations as "small scale transactions" and require test interest rates of 9% or 80% of the applicable federal rate, whichever is lower.

We urge Congress to act quickly and enact the above outlined solution to the imputed interest controversy before July 1, 1985. We would be plea·ed to answer any questions that the Committee might have on this subject.

APPENDIX A

REVENUE ESTIMATES OF CHANGES IN IMPUTED INTEREST RULES INCLUDED IN THE TAX REFORM ACT OF 1984

Congress has estimated that the changes in the imputed interest rules affecting both seller financing and assumptions of existing financing included in the Tax Reform Act of 1984 would raise $2.2 billion of additional revenue over the 1985 to 1987 period (an average of $0.77 billion per year). As is typical of such revenue estimates this figure is based on static analysis. That is, different tax rules are applied to estimates of future levels of economic activity without taking account of the impact those different tax rules would have on the future levels of economic activity. In contrast, dynamic analysis does take account of the impact of the proposed tax law changes on the level of economic activity. Consequently, dynamic revenue estimates can be and frequently are substantially different from static revenue estimates. Using dynamic analysis it can be demonstrated that the net revenue gain to the federal government of these pending imputed interest rules changes is quite likely to be negative.

A. INCOME PRODUCING PROPERTY (MULTI-FAMILY, COMMERCIAL, AND INDUSTRIAL)

The current stock of these types of properties is estimated at $3 trillion. It is estimated that about 3.5 percent of this stock turns over each year, putting annual sales at about $105 billion. Based on surveys of members of the National Association of Realtors, seller financing and assumptions of existing loans is involved in nearly 50 percent of the sales of these types of properties, suggesting that about 30 percent or $31.5 billion of these sales would be lost due to these rules changes. Analysis suggests that the contribution to GNP of these sales is about 15 percent of the dollar volume of sales, resulting in $4.73 billion of lost GNP. Federal revenues represent about 20 percent of GNP, resulting in about $0.95 billion of lost federal revenues.

B. PRINCIPAL AND NONPRINCIPAL RESIDENCES

Data indicates that just 2.5 percent of the sales of existing single-family sales are for properties costing $250,000 or more. At an average price of $400,000 and the long-run average of existing home sales at 3 million per year, that represents $30 billion of annual sales in this category of properties. It is estimated that 15 percent or 11,250 sales valued at $4.5 billion would be lost due to the imputed interest rules changes affecting seller financing and assumptions. In the case of single-family homes, the contribution to GNP is 20 percent of sales volume. Consequently, the loss of GNP is $0.9 billion while the loss of federal revenues is about $0.18 billion.

C. FARMS

According to the U.S. Department of Agriculture about 0.4 percent of the 2.4 million farms in the U.S. are valued at $1 million or more. That means that about 10,000 farms with an average value of about $1.5 million would be affected by the proposed imputed interest rules affecting seller financing and assumption. The historicial turnover rate for farms is about 2 percent, putting annual sales in this price category at about $0.3 billion. About 40 percent of farm sales are seller financed while another 20 percent involve assumptions. Analysis suggests that half of these sales (30 percent of all sales) would be lost for a total lost sales volume of $0.09 billion. The contribution off arm sales to GNP is estimated at 10 percent of sales volume. Therefore, lost GNP is estimated at $0.009 billion while the loss of federal revenues is about $0.0018 billion.

Table 1 summarizes the annual loss of GNP, jobs, federal revenues, and state and local revenues from the imposition of these more restrictive imputed interest rules. In regard to federal revenues, this loss must be netted against that expected increase in revenues. Of course, with a lower level of economic activity, the dynamic gross revenue gain will be less than the static gross revenue gain. Table 2 presents these alternative gross revenue estimates and demonstrates that the net revenue position of the federal government is likely about −$0.59 billion per year. At projected inflation rates it is quite likely that over the 1985 to 1987 period the net federal revenue loss would approach $2 billion.

TABLE 1.—ESTIMATED ANNUAL LOSS OF GNP, JOBS, FEDERAL REVENUES, AND STATE AND LOCAL REVENUES RESULTING FROM PROPOSED CHANGES IN IMPUTED INTEREST RULES

	GNP (billions)	Jobs	Federal revenues (billions)	State and local revenues (billions)
Property category:				
Multifamily, commercial and industrial	$4.73	94,600	$0.95	$0.61
Principal and nonprincipal residences	.9	18,000	.18	.12
Farms	.009	180	.0018	.0012
Total	5.639	112,780	1.132	.7312

Source: National Association of Realtors.

TABLE 2.—*Determination of net Federal revenue position from proposed imputed interest rules changes*

[In billion of dollars]

Annual static gross revenue gain	$0.77
Annual dynamic gross revenue gain	.54
Annual dynamic gross revenue loss	1.32
Annual dynamic net Federal revenue position	−.59

LOSS OF GNP, JOBS, AND TAX REVENUES BY STATE

State	GNP	Full-time jobs	Tax revenues
Alabama	$103,813,360	2,076	$34,604,453
Alaska	8,165,814	163	2,721,938
Arizona	37,031,819	741	12,343,940
Arkansas	72,143,134	1,443	24,047,711
California	591,980,354	11,840	197,326,785
Colorado	75,846,621	1,517	25,282,207
Connecticut	91,721,497	1,834	30,573,832
Delaware	15,828,835	317	5,276,278
District of Columbia	23,038,318	461	7,679,439
Florida	144,548,418	2,891	48,182,806
Georgia	163,015,625	3,260	54,338,542
Hawaii	7,014,251	140	2,338,084
Idaho	16,247,031	325	5,415,677
Illinois	283,619,548	5,672	94,539,849
Indiana	169,808,637	3,396	56,602,879
Iowa	52,368,351	1,047	17,456,117
Kansas	44,412,374	888	14,804,125
Kentucky	86,053,334	1,721	28,684,445
Louisiana	101,143,883	2,023	33,714,628
Maine	56,659,309	1,133	18,886,436
Maryland	76,778,201	1,536	25,592,734
Massachusetts	193,469,432	3,869	64,489,811

LOSS OF GNP, JOBS, AND TAX REVENUES BY STATE—Continued

State	GNP	Full-time jobs	Tax revenues
Michigan	221,564,206	4,431	73,854,735
Minnesota	102,092,428	2,042	34,030,809
Mississippi	71,582,813	1,432	23,860,938
Missouri	128,160,498	2,563	42,720,166
Montana	11,304,900	226	3,768,300
Nebraska	22,059,441	441	7,353,147
Nevada	6,971,410	139	2,323,803
New Hampshire	41,659,637	833	13,886,546
New Jersey	228,885,290	4,578	76,295,097
New Mexico	15,680,820	314	5,226,940
New York	426,266,917	8,525	142,088,972
North Carolina	268,483,236	5,370	89,494,412
North Dakota	7,209,447	144	2,403,149
Ohio	320,551,754	6,411	106,850,585
Oklahoma	62,952,939	1,259	20,984,313
Oregon	66,973,698	1,339	22,324,566
Pennsylvania	362,990,928	7,260	120,996,976
Rhode Island	48,729,823	975	16,243,274
South Carolina	110,064,415	2,201	36,688,138
South Dakota	6,271,247	125	2,090,416
Tennesssee	162,630,821	3,253	54,210,274
Texas	429,512,815	8,590	143,170,938
Utah	23,416,877	468	7,805,626
Vermont	11,010,072	220	3,670,024
Virginia	143,008,473	2,860	47,669,491
Washington	89,232,786	1,785	29,744,262
West Virginia	41,373,259	827	13,791,086
Wisconsin	139,337,476	2,787	46,445,825
Wyoming	15,313,432	306	5,104,477
Total	6,000,000,000	120,000	2,000,000,000

Source: National Association of Realtors.

APPENDIX B

IMPACT OF IMPUTED INTEREST AND OID ON NET PRESENT VALUES

Scenario	Seller	Buyer	Treasury
Case I: Straight land deals:			
(1) OID invoked without price changes	−$306,529	+$368,612	−$62,083
(2) Prices changed to match OID value	−175,743	+175,743	
Case II: Income property deals:			
(1) OID invoked without price changes	−306,529	+110,882	+195,647
(2) Prices changed to match OID value	−175,743	−81,722	+257,465

Major assumptions.—In both cases, purchase price without OID is $10 MM property with $2.5 MM cash, and PMM of $7.5 MM @ 9%, interest-only, ten years. In Land Deal there is no depreciable basis; in income property deal, the depreciable basis without OID is $8 MM, 18-years, ACRS, Section 1250 recapture. The Federal rate is assumed to be 11%, safe harbor 12.1% and discount rate 13.2% per annum. Imputed interest calculated as $1,744,729 over the ten-year period, so in scenarios (2) the revised prices and mortgage amounts are that much less, with interest at 13.2% per annum.

In all instances, figures are changes in 10-year net present values from a baseline scenario in which prices are $10 MM and there is no OID invoked (i.e., current law).

As can be seen, there is either no pick-up to treasury or additional tax expenditures for the case involving land deals. In all instances, there is every reason to believe that buyer and seller can concur on or arrive at a mutual strategy which maximizes their overall gain without necessarily meeting the goals desired by Treasury.

IMPUTED INTEREST AND TAX EXPENDITURES—A PRESENT VALUE APPROACH

Scenario.—Straight Land Deal.

Seller.—Acquired land at low cost many years before, and now sells to buyer under the terms below. Seller is in a 50% tax bracket and qualifies for capital gains (not a dealer):

Price	$10,000,000
Cash down, Jan. 1, 1986	2,500,000
Purchase money mortgage at 9% interest-only, due in full in 10 years	7,500,000

Buyer.—Purchases land under the terms above and sells after 10 years on 12/31/95. For analysis purposes, presume the parcel appreciates at 15% per year, compounded, less a 6% allowance for brokerage expenses upon ultimate disposition, buyer is also in a 50% tax bracket, and qualifies for capital gains (not a dealer).

Federal Government.—Imposes OID on deals involving mortgages greater than $4,000,000 and the applicable federal rate is 11% per annum, so interest is imputed at 120% of 11%, or 13.2% per annum. Over the ten-year period of the note, the total interest forgone is calculated as $1,744,271 using present value analysis.

ANALYSIS OF TREASURY'S POSITION

Time period	Seller	Buyer
Jan. 1, 1986	Ahead $87,214	Even.
Each month	Down $87,214	Ahead $87,214.
Dec. 31, 1995	Ahead $261,640	Down $348,854.

Summary: Treasury is down $87,214 on Jan. 1, 1986. Treasury is even each month. Treasury is down $87,214 on Dec. 31, 1966. Overall, Treasury is down $62,083 in present value terms using a discount rate of 13.2 percent.

ANALYSIS OF BUYER'S POSITION

	Without OID	With OID
Cash down, Jan. 1, 1986	$2,500,000	$2,500,000
Interest paid per year	675,000	675,000
Imputed interest per year	0	+174,427
Interest expense per year	675,000	849,427
Taxes saved at 50 percent per year	337,500	424,713
Net interest paid per year	337,500	250,286
Amount received Dec. 31, 1995	38,028,232	38,028,232
Less mortgage balance	7,500,000	7,500,000
Proceeds before taxes	30,528,232	30,528,232
Adjusted basis upon sale	38,028,232	38,028,232
Original basis	10,000,000	8,255,729
Capital gain	28,028,232	29,772,503
Capital gains tax at 20 percent	5,605,647	5,954,500
Net proceeds	24,922,586	24,573,732

Summary: Buyer is even on Jan. 1, 1986. Buyer is ahead $87,214 each month. Buyer is down $348,854 on Dec. 31, 1995. Overall, buyer is ahead $368,612 in present value terms using a discount rate of 13.2 percent.

ANALYSIS OF SELLER'S POSITION

	Without OID	With OID
Sale price	$10,000,000	$10,000,000
Interest forgone	0	1,744,271
Adjusted basis	10,000,000	8,255,729
Original basis (presumed minuscule)	0	0
Capital Gain (total)	10,000,000	8,255,729
Amount received Jan. 1, 1986	2,500,000	2,500,000
Allocated gain	2,500,000	2,063,912
Capital gains tax at 20 percent	500,000	412,786
Net received Jan. 1, 1986	2,000,000	2,087,214
Interest Received/year	675,000	675,000
Imputed Interest/year	0	174,427
Taxable Interest/year	675,000	849,427
Taxes at 50 percent year	337,500	424,713
Net Interest/year	337,500	250,286
Amount received Dec. 31, 1995	7,500,000	7,500,000
Allocated gain	7,500,000	6,191,797
Capital gains at 20 percent	1,500,000	1,238,360
Net received Dec. 31, 1995	6,000,000	6,261,640

Summary: Seller is ahead $87,214 on Jan. 1, 1986. Seller is down $87,214 each month. Seller is ahead $261,640 on Dec. 31, 1995. Overall, seller is down $306,529 in present value terms using a discount rate of 13.2 percent.

STATEMENT OF STEPHEN D. DRIESLER, EXECUTIVE VICE CHAIRMAN, NATIONAL MULTI HOUSING COUNCIL

Mr. DRIESLER. Thank you, Mr. Chairman. My name is Steve Driesler. I am executive vice president of National Multi Housing Council.

I have a statement which I would like to place in the record at this time. I believe that my time here can best be spent summarizing my members' position and also responding to a couple of questions that were raised by members with Mr. Pearlman and a couple of issues that Mr. Pearlman addressed, and we think incorrectly.

I think we all agree that there should be a simple as possible solution to these complex, costly, and inflexible imputed interest rules that were put in the Deficit Reduction Act of 1984.

The National Multi Housing Council believes that what the Congress should look at are those transactions which are, because of their size or their structure, nonabusive and treat them under one set of rules and those transactions which, because of their size or their structure, have some potential of abuse and treat them under a different and more stringent rule.

I think Treasury has substantially concurred that small transactions with unsophisticated parties on both sides should basically be excluded from these rules with a 9-percent test rate.

Where we differ with Treasury is that even larger transactions than the $2 million or the $4 million or whatever threshold the committee seeks to establish can still be nonabusive and, therefore, should not be subject to these complex, costly, and unwarranted regulations.

I would like to address the example that Mr. Pearlman used in his testimony, and that is a $10 million transaction, at 80 percent of the applicable Federal rate. According to Treasury's own estimates this transaction overstates basis by 30 percent. But, gentlemen, that was for a 30-year loan. Loans, in a typical seller financed on apartment buildings, do not run 30 years. They run 5 to 10 years. If Treasury would give you those numbers, at 80 percent of the applicable Federal rate for a $10 million apartment building there would no overvaluation of basis. Treasury also assumes the entire sales price is seller financed. A more realistic amount may be 20 or 30 percent, or less, seller financing. But, even assuming the full sales price, you would find miniscule, miniscule overstatement of basis under that scenario because, as Mr. Pearlman pointed out, the key to abuse is low interest rate and a long period of time. If you do not have both of those, and even at the 80-percent rate, or 9 percent under current law, if you are talking about transactions of 10 years or less, or 12 years or less, there is simply not a potential for large overstatement of basis and, therefore, no significant tax distortion. These types of transactions should not be included under a 110 test rate or the complex OID accounting methods.

The other area of abuse, which Mr. Pearlman pointed out, is the mismatching of income and deductions. I do not think there is a single industry representative here today who will testify that we do not support the elimination of mismatching in these transactions. Whether that be cash-cash or accrual-accrual, the same objective is accomplished. There is no significant revenue impact to the Treasury whether you put both parties on cash-cash or on accrual-accrual. It ought to be left up to the parties to determine which method best suits their needs. That is part of the flexibility that we are talking about.

The last point I want to address is the talk about a test rate based on some market index. We all agree to that in theory. Where we disagree is what is the proper index. We submit that the applicable Federal rate, based upon Treasury bonds, is not the proper index, gentlemen.

Real estate is not a bond. It does not behave like a bond. Its value does not fluctuate based upon daily interest rates like bonds do and, therefore, we need a more stable interest rate and a more predictable interest rate. We submit that another index, such as the Federal Home Loan Bank Board's cost of funds will provide a more stable, predictable interest rate index upon which to base and judge these transactions.

By now you should have received a copy of my testimony. I would like to refer you to the chart at the back of that testimony which tracks the fluctuations of the Federal rate for 1-year Treasury bonds and the cost of funds over several years. I think that graphically demonstrates the volatility of the applicable Federal rate, the Treasury bond rate versus the stability and predictability of the cost of funds. That is why we feel the cost of funds is a better index.

Thank you very much.

[The prepared statement follows:]

STATEMENT OF STEPHEN D. DRIESLER, EXECUTIVE VICE PRESIDENT, NATIONAL MULTI HOUSING COUNCIL

SUMMARY

Real estate is a physical asset which has intrinsic value apart from its current earnings stream; therefore, mortgages thereon should not be treated for Federal income tax purposes as if they were solely money market obligations whose values fluctuate with daily interest rates.

The permanent imputed interest rules sharply curtail the flexibility to tailor financing terms, which previously enabled buyers and sellers of rental housing to maintain a market for these assets under difficult economic conditions.

The use of the so-called "applicable Federal rate", which represents the Treasury's average cost of involuntary borrowing, results in excessive interest requirements for seller-financing of rental housing.

The "cost of funds" index which represents the average cost of mortgage money obtained by savings institutions would be a more appropriate standard for seller financing since it rises and falls more slowly than the AFR and is less sensitive to short-term market fluctuations.

The current 9% test rate for small transactions (i.e., less than $2 million) should be expanded to include all seller financed real estate so long as the term is 12 years or less, interest is compounded and both buyer and seller use matching accounting methods. Such requirements would adequately measure interest costs for Federal tax purposes at current interest rate levels. Therefore, transactions meeting these requirements should not be subject to the extreme complexities and costs of the 1984 Act.

STATEMENT

Mr. Chairman and Members of the Committee on Ways and Means, my name is Stephen Driesler, and I am the Executive Vice President of the National Multi Housing Council. The National Multi Housing Council is a nationwide organization of over 6,000 members, representing all aspects of the rental housing industry. Together, NMHC members own or operate hundreds of thousands of rental housing units.

The National Multi Housing Council is grateful to this Committee for addressing the difficult issue of imputed interest so promptly, in order that permanent relief legislation can be enacted before the expiration of last year's stopgap provisions on July 1, 1985. Seller financing is often essential for the purchase of rental housing because of the relatively substantial sums of money which are involved in such transactions. Accordingly, the 1984 legislation impacts very severely on developers and owners of rental housing and on the potential market for such assets.

Even with the stopgap legislation enacted last October, the Deficit Reduction Act of 1984 now requires that purchase-money financing for all but the most modest of apartment buildings state an interest rate of no less than 110% of the so-called "applicable Federal rate" ("AFR") in order to avoid the imputation of interest at 120% of the AFR. If the stated interest payments are not deemed "adequate" under this statute, or if interest payments are not required to be made currently, taxable interest income will be charged to the seller under a complex formula which allocates the difference between the deemed purchase price (after its adjustment for imputed interest) and the total deferred payment amount into daily portions which must be aggregated for each taxable period. In addition, when interest is imputed, payments from the buyer which were intended to represent the purchase price are recharacterized as interest, thereby reducing the buyer's cost basis in the property.

Clearly, these rules are complex and require extensive computations. However, perhaps the most significant adverse impacts on the rental housing industry from these provisions result from their inflexibility. During recent periods of high interest rates, buyers and sellers of rental housing were forced to devise alternative methods for financing these transactions because outside financing was unaffordable. For example, it was not uncommon for sellers to state a low interest rate at sale because the present income from the property could not support additional debt service. However, the seller would also take a percentage of the increase in rental income and/or a portion of the proceeds from refinancing or sale as additional interest.

There are a large variety of ways in which such transactions can be structured. Common variations include a minimum, stated interest charge, whether or not paid currently, and an additional, contingent interest charge, the amount of which is measured by either a percentage of net income or a percentage of net proceeds from refinancing or resale. It is generally not possible to predict with accuracy how much interest will actually be received under such arrangements, even though there is a real expectation that substantial interest will be realized. Further, although not susceptible to calculation at the origination of the loan, such contingent interest is generally sufficient to provide a rate of return at least equal to a commercial rate. These variations, however, important as they are to real estate buyers and sellers, do not lend themselves to the rigidities of the deferred payment rules. Accordingly, the Federal income tax treatment of such contingent payments under the permanent deferred payment rules is still unclear almost nine months after their enactment.

The nonrecognition of contingent financing is but one example of how the ability of buyers and sellers to negotiate transfers of property according to the best and most mutually affordable arrangement will be critically encumbered by the rigidity of the Federal income tax consequences. In addition, in some jurisdictions the AFR has exceeded the maximum rate allowable under state usury statutes, and, therefore, compliance with the tax law would be illegal in those places.

Another problem which has already been partially addressed in temporary Treasury regulations is the so-called "time lag" problem with the AFR. As originally, drafted, the AFR was to be determined based on comparable term Treasury rates during the preceding three to fifteen months. In a period of falling interest rates (such as has occurred since enactment of the Deficit Reduction Act), buyers and sellers are required to use above-market interest rates in their transactions or suffer the penalty of having an even higher rate imputed for Federal income tax purposes. The Treasury has not provided for the election of a monthly rate (computed as of the fourteenth day of the preceding month) in lieu of the semi-annual AFR, which alleviates but does not completely eliminate this problem. A lapse of several weeks can still produce significant variations in interest rates which when compounded over twenty to thirty years in a multi-million dollar real estate transaction is considerable cost. By the Treasury's own admission, however, use of a more frequent AFR greatly increases the complexity of the interest computations, in effect requiring every taxpayer to renegotiate, according to the daily Wall Street Journal, transactions which may have begun weeks or even months before.

Further, mandating such precise adjustments in interest rates will result in frequent, significant and fallacious fluctuations in the values of all real estate assets. Unlike a Treasury bill or other money market instruments, rental housing has value apart from the mere income stream which it currently produces; it is a durable, physical asset which will outlast many economic cycles. Accordingly, temporary fluctuations in interest rates do not have so substantial and direct an impact on the real values of such assets as would be reflected in the "values" computed under the current deferred payment provisions. These rules effectively adjust the market values of real property for every change in interest rates.

Whereas, the value of a $1 million discount bond with a 10% yield could be reduced by as much as one-third after an interest rate increase of 500 basis points, an apartment building worth $1 million, producing a 10% current cash return, need not lose one-third of its value in similar circumstances. The value of a bond is determined solely according to its yield. The logic of the 1984 imputed interest rules carried to its extreme would treat leveraged real estate as if it, too, were merely a money market instrument. This is neither realistic nor reflective of the market. There is the value of the land; there is the cost of the materials and labor necessary to replace the structure; there is its potential for other uses. Certainly, an empty building is not worth as much as a fully occupied building generating cash flow, but unlike a bond, its value is only partially dependent on the cash it currently throws off.

The ability of sellers to offer flexible purchase-money financing is one mechanism for maintaining stable price levels for real estate and predictability in the real estate markets in periods of unusually high interest rates. Such long-term stability and predictability are essential components of the confidence necessary to induce investors to purchase rental housing, which by its very nature is a long-term investment, permitting the markets therein to operate fairly and effectively.

Finally, under the stopgap legislation, mortgage financing originated after October 16, 1984 and assumed by a purchaser would be subject to readjustment under the deferred payment rules, even though the original financing had adequate stated interest at the time of its creation, the terms and conditions thereof are not altered and the original lender is not a party to the subsequent transfer. The carryover of existing financing is standard practice in real estate transfers. Requiring that such prior financing be readjusted to reflect current interest rates for Federal income tax purposes when the actual payments due to the original lender under the instrument are unchanged produces results which are absurd in practice. For example, theoretically, the original lender whose financing is assumed at a time when interest rates have risen would recognize an immediate bad debt deduction which would be recouped through taxable imputed interest payments (aggregating to the amount of the bad debt deduction) over the remaining loan term. This would afford most lenders substantial current income tax deferral and undoubtedly result in significant losses in Federal revenues.

Because of these problems of complexity, inflexibility and over-sensitivity to interest rates, the National Multi Housing Council believes that significant modifications to the current deferred payment rules are necessary. First, some minimum threshold level should be established so that transactions entailing purchase money financing of less than the threshold amount would not be subject to variable interest rates but would be entitled to use a fixed minimum interest rate (or, if lower, elect a minimum adjustable rate). Further, parties to such small transactions should be entitled to use cash method accounting provided that both buyer and seller agree to do so. Sufficient information has been provided to this Committee concerning the proper threshold amount, and the National Multi Housing Council defers to the expertise of others on this issue.

Second, any assumed financing which had adequate stated interest at the time of its creation should not again be subject to adjustment under the deferred payment provisions. Accordingly, so long as the terms and the conditions thereof are not materially altered, assumptions of financing which did not entail original issue discount should not become discount obligations for Federal tax purposes because of subsequent events.

Third, a more stable index than the AFR should be used to measure the adequacy of interest on purchase money financing. The AFR represents the price that the Treasury must pay to borrow in the money markets on an essentially involuntary basis. Because the timing of such Treasury borrowing is not discretionary, it pays rates which will fluctuate widely according to external events which influence professional investors and speculators. A preferable alternative would be the Federal Home Loan Bank Board's "cost of funds" index which is a weighted average of the cost paid by savings institutions (which are significant mortgage lenders) for their own capital. This index is far more relevant to real estate financing than the AFR because it represents the lender's own cost of mortgage money. Most importantly for the rental housing industry, however, is the fact that the cost of funds rate has been far less volatile than Treasury borrowing rates on both the upside and the downside. (See Exhibit A for a chart comparing the cost of funds index with the AFR.) Therefore, its use would lend necessary and desirable stability to the real estate markets.

Whatever index is used—be it AFR, cost of funds or some alternative—the test rate must be set at a level which is realistic based on historical trends in real estate financing and which permits transactions to continue during temporary periods of high interest rates. For example, the use of eighty percent of the AFR, which has been proposed by numerous members of Congress, is a much more realistic measure than the 110% of AFR now required by law for large transactions.

Finally, before imposing such complex and inflexible rules as imputed interest and original issue discount on a wide range of transactions, this Committee should carefully reconsider what it is trying to achieve and craft legislation which deals with potential abuses but does not interfere with ordinary, non-abusive seller financing. According to Treasury, there are three areas of potential abuse:

1. *Mismatching of income and deductions.* Mismatching occurs when the buyer and seller use different methods of accounting, allowing tax deductions to be taken by one party without corresponding income recognition by the other. This problem, however, can be easily solved by requiring both buyer and seller to use the same method of accounting for each transaction. The National Multi Housing Council further urges this Committee to allow the option of either cash-cash or accrual-accrual accounting since either approach solves the mismatching problem without significant revenue implications to the Treasury.

2. *Artificial accrual of interest.* Various methods of calculating interest distort the interest component in real estate transactions. The rule of 78s overstates interest in the early years, and simple interest understates it in the later years. The use of compound interest is a more appropriate method of determining interest, and the National Multi Housing Council supports this change in the law.

3. *Overvaluation.* The last and only remaining potential abuse is the use of interest rates that are artifically low over a long period. This can significantly increase the buyer's cost basis in the property and understate the portion of the purchase

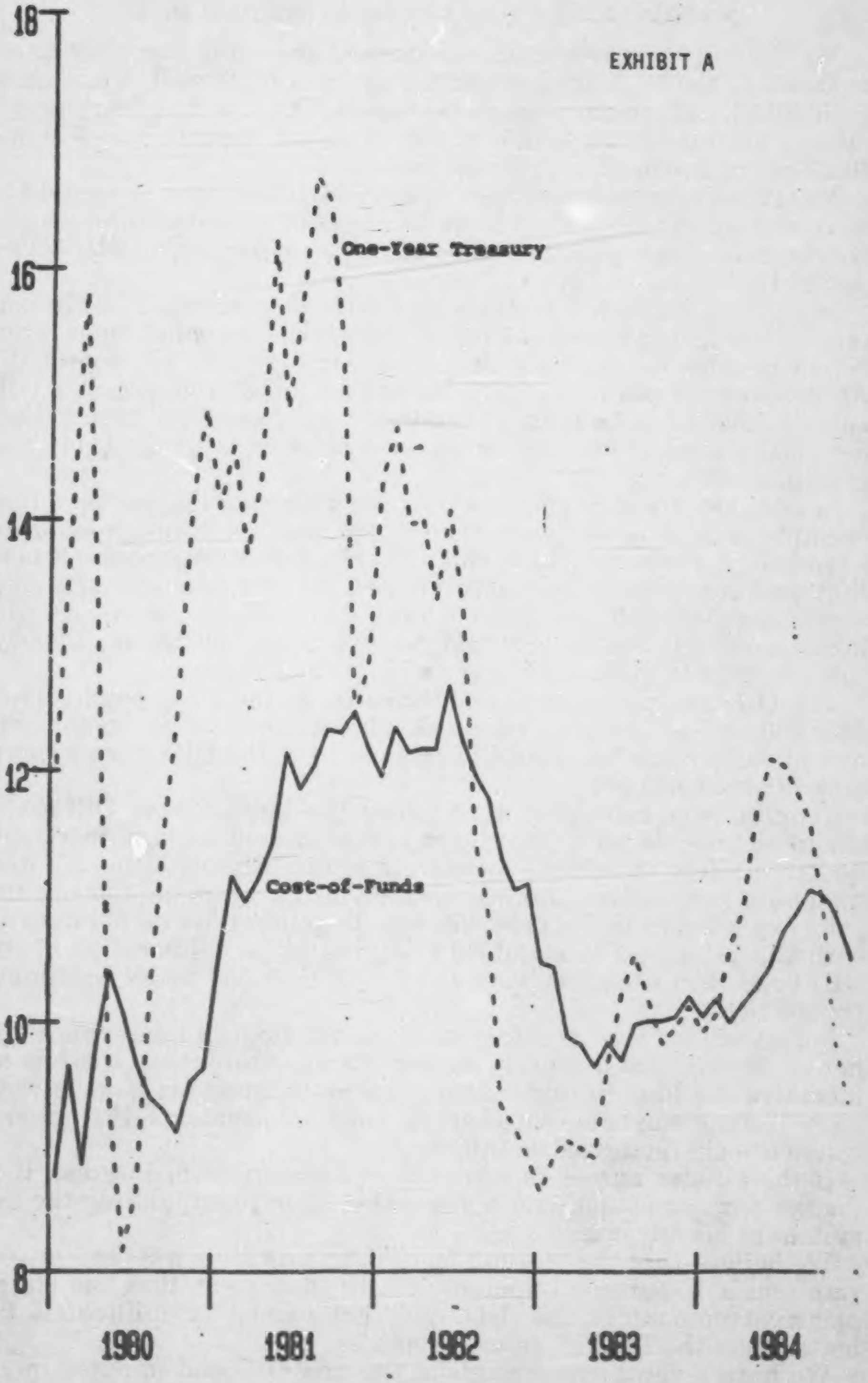
price which should be taxed to the seller as interest income (ordinary income) in lieu of capital gains.

Very few seller-financed transactions now fall into this third category. Even the 9% test rate now used in transactions of less than $2 million, if applied on a compound basis and with a term no longer than 12 years, would not significantly distort either property values or Federal income tax liability regardless of the size of the seller financing. Therefore, why should such a transaction, even if it were for $10 million, be subject to these complex and inflexible original issue discount and imputed interest rules? We submit that it should not be.

Accordingly, the National Multi Housing Council recommends that this Committee expand the category of transactions entitled to the 9% test rate now in the interim rule, retaining the requirements of compound interest computations and matching accounting methods for both buyers and sellers, to include all transactions with financing terms not exceeding 12 years. In addition, a trigger mechanism could be enacted to require indexed test interest rates whenever market interet rates rise or fall to designated levels. At the present time, the National Multi Housing Council believes that the transaction costs of complying with these very complex and difficult provisions will significantly outweigh any revenue savings to the Treasury from their use.

The National Multi Housing Council recognizes the commitment of the Chairman of this Committee to revise the income tax rules regarding deferred payment transactions without revenue cost to the Treasury. However, the National Multi Housing Council believes that, under current economic conditions with reduced and falling interest rates, the revenue gains to be expected from application of these complex provisions are minimal and, further, that equivalent revenues could be obtained from simply requiring the use of compound interest and matching accounting methods. During periods of relatively low interest rates, the problem of below market seller financing is not sufficient to warrant the complexity introduced by the permanent imputed interet provisions. Further, even in periods of high interest rates, those provisions would mandate an excessive, inaccurate and inflexible measure of the costs of seller financing and would impose an undue burden and cost on the rental housing industry.

EXHIBIT A



Source: Federal Home Loan Bank Board of San Francisco
Eleventh District Cost of Funds

STATEMENT OF DAVID C. SMITH, FIRST VICE PRESIDENT, NATIONAL ASSOCIATION OF HOME BUILDERS

Mr. SMITH. Mr. Chairman, members of the committee: My name is David C. Smith. I am a homebuilder from McDowell, VA. I build residential and commercial properties in Virginia and Maryland. I appear here today on behalf of the National Association of Home Builders, of which I am first vice president.

NAHB represents more than 130,000 members, and is pleased to have this opportunity to present its views on imputed interest and the original issue discount rules enacted in the Deficit Reduction Act of 1984.

In general, DEFRA imposes a test interest rate equal to 110 percent of the Federal rate. If the test rate is not satisfied, then interest rates must be imputed at a rate equal to 120 percent of the AFR. Several types of transactions are excluded from the new OID rules, including transactions involving total payments, total principal and interest of $150,000 or less and sales by individuals of their principal residences.

In addition, there is a special rule for personal use property that exempts cash method buyers of property which will not be used for a trade or a business. Under this rule, if a homebuyer issues a note that does not provide adequate interest for the purchase of a new home, even though the builder may have income to report, the homebuyer will not receive the corresponding deduction. Clearly, this amounts to mismatching in favor of the Treasury.

The OID exception for transactions involving total payments of $250,000 or less is not as generous as it appears to be. In the context of today's market, it would exclude from the OID rules a mortgage of about $65,000.

Congress was concerned that under the law prior to DEFRA it would be possible for taxpayers in a sale of nontraded property for nontraded debt to achieve unwarranted tax benefits either by mismatching interest income and deductions or by manipulating the principal amount of the debt, or both. In general, we do not quarrel with the principles that guided Congress in its deliberation of the OID rules. But Congress went too far. It included many legitimate transactions.

For example, take the case of a typical homebuilder. Since the homes he sells are inventory rather than capital assets, there is no incentive for him to understate interest because his gain is ordinary income anyhow, whether or not the payments that he receives are characterized as interest.

If the builder agrees to accept a moderate rate of interest, it is for the purpose of selling a home rather than manipulating the tax system to his advantage.

We believe that the stopgap legislation providing a 9-percent test rate and a 10-percent imputed rate, to the extent that the stated principal amount of the debt does not exceed $2 million, is far better than the DEFRA rules it replaces.

We have several concerns about the new OID and imputed interest rules. First, the DEFRA rules build high interest rates into seller financing. Under the current rules, a builder would have to require a 13.49-percent interest rate even though the current VA rate is 12.5 percent. This makes no sense at all and seems very unfair and unreasonable.

Second, the new rules will increase interest rates that ultimately will have to be passed on to the consumers, adding to the cost of housing and the affordability problem we have in this country today.

Third, the new rules would adversely affect investment in low income housing.

The OID and the imputed interest rules have created major problems both from a technical and a policy viewpoint. Thus, the NAHB believes that Congress should reconsider the entire issue. Ideally, NAHB would prefer that the OID and the imputed interest provisions be repealed. We appreciate the efforts that Representative Archer and others have made in that regard. Although short of repeal, we also support the efforts of Representative Matsui and others on the committee to find a workable solution to the problem, and commend them for their action.

At a minimum, we believe that a more realistic provision should be enacted. We feel that the test rate should be no higher than 80 percent of the AFR and that the imputed rate should be no higher than 100 percent of the AFR. Moreover, we believe it would be appropriate for the Committee to retain the threshold concept, and we suggest a threshold of $4 million.

Furthermore, we believe that if a permanent threshold is adopted, it should be clear that the threshold amount applies to each separate residence, cooperative, or condominium unit sold to a separate buyer. We also feel that assumption of loans, whenever they originated, should be excluded from the OID and the imputed interest rules.

Finally, we strongly believe that the issue of OID and imputed interest should be kept separate from the issue of homeowner bonds. Since the two issues deal with separate situations we feel it is appropriate for Congress to consider them separately.

I would like to thank you for the opportunity to appear before you this morning, and would be pleased to answer any questions you may have.

[The prepared statement follows:]

STATEMENT OF DAVID C. SMITH, FIRST VICE PRESIDENT, NATIONAL ASSOCIATION OF HOME BUILDERS

Mr. Chairman and members of the committee, my name is David C. Smith. I am a homebuilder from McDowell, Virginia, and build residential and commercial properties in Maryland and Virginia. I appear here today on behalf of the National Association of Home Builders (NAHB), of which I am First Vice President. NAHB, which represents more than 130,000 builders, is pleased to have this opportunity to present its views on the imputed interest and original issue discount (OID) rules enacted in the Deficit Reduction Act of 1984 (DEFRA) and the stopgap legislation that is due to expire on July 1, 1985.

Let me note at the outset that NAHB generally supported deficit reduction legislation last year, even though it significantly increased taxes upon the real estate industry. However, a major concern for us was the OID provisions and the related imputed interest changes. We are concerned with the effect of these changes upon the sales of homes, raw land, multifamily and commercial structures, family farms, and small businesses.

Seller-financed installment sales of property have become an increasingly popular alternative to commercial financing. In order to consummate sales, parties dealing at arms-length in such transactions often are willing to negotiate interest rates that are lower than those charged by commercial lenders. Many sales of property never would occur without this ability to negotiate lower interest rates. The effect of DEFRA's modification of the OID rules and imputed interest rules is to force parties dealing at arms-length to negotiate interest rates that are equal to, or higher than, commercial rates, or else face adverse tax consequences. These provisions severely will impair the ability of many property owners to sell their property during times of high interest rates.

NAHB, therefore, believes that Congress should re-examine the entire issue of imputed interest and OID. We are pleased that the Ways and Means Committee is conducting a comprehensive analysis of the subject, and are encouraged by the Chairman's hope and expectation that permanent, revised imputed interest rules will be enacted prior to the expiration of the stopgap provisions of July 1, 1985. Furthermore, we hope to work with the Committee, in a constructive and responsible manner, in order to devise a workable solution to the problems surrounding deferred payment sales of property.

At a minimum, NAHB believes that the DEFRA rules should be revised substantially. For example, we feel that a cap (perhaps 12 percent) should be placed as an upper ceiling for OID and imputed interest rates. Alternatively, a method could be provided to prevent the mandated interest rate from rising too sharply from one period to the next. Moreover, we believe that the test interest rate should be no higher than 80 percent of the Applicable Federal Rate (AFR) and that the imputed rate should be no higher than 100 percent of the AFR. Finally, we believe that realistic dollar exemptions should be provided for transactions involving sales of homes, raw land, multifamily and commercial structures, family farms, and small businesses.

I will now discuss, in greater detail, the tax treatment of imputed interest on deferred payment sales of property.

I. OID AND IMPUTED INTEREST RULES

OID

DEFRA modified and expanded the OID rules of prior law. Most significantly, it extended those rules to debt instruments that are issued for property, where neither the instrument nor the property received for it is traded publicly, and to obligations issued by individuals. The new rules, thus, apply to any debt instrument (bond, debenture, note, or other evidence of indebtedness) issued in exchange for real estate, machinery, or other property.

Under the new OID rules, the difference between the issue price of an obligation and its stated redemption price at maturity is included in the income of the seller (as interest income) and generally is deductible by the borrower (as interest expense) under a mandatory accrual method of accounting and utilizing the constant interest rate method of allocating interest over the term of the contract. An obligation's issue price is its stated principal amount, unless there is inadequate stated interest. The stated redemption price at maturity is the total amount, including interest, which is payable at maturity reduced by any interest unconditionally payable at a fixed rate, at fixed periodic intervals of one year or less, during the entire term of the debt instrument.

DEFRA requires that where a debt instrument is issued for nontraded property, the stated principal amount of the obligation must be tested by discounting all payments to be made at a rate of 110 percent of the AFR. If the stated principal amount is greater than the test amount, then an imputed principal amount is derived by discounting all payments to be made under the instrument at a rate equal to 120 percent of the AFR. The resulting OID must be amortized over the life of the instrument by both the issuer (buyer) and holder (seller).

Several types of transactions are excluded from the new OID rules. These transactions include the following:

Transactions involving total payments (principal and interest) of $250,000 or less;

Transactions in which all payments are due within six months or less after the date of sale or exchange;

Sales by individuals of their principal residences;

Certain sales of farms by individuals and small businesses (if the sales price does not exceed $1 million);

Sales of certain patents;

Certain sales of land between related parties ($500,000 limitation); and

Obligations containing a de minimis amount of OID.

In addition, there is a special rule for personal use property that exempts cash-method issuers (but not holders) of debt instruments issued in exchange for property substantially all of which will not be used by the issuer in a trade or business. Thus, such issuers may claim interest deductions only for amounts actually paid during the taxable year. Suppose a home buyer issues a note for the purchase of a new home and the note does not provide for adequate interest. What this provision means is that while the builder may have phantom income to report due to the imputation of interest, the home buyer will not receive a corresponding deduction. Clearly, this amounts to mismatching in favor of the Treasury.

The first OID exception I mentioned (transactions involving total payments of $250,000 or less) is not as generous as it appears. In the context of today's market, it would exclude from the OID rules a mortgage of about $65,000.

Basically, the OID rules seek to recharacterize the principal and interest elements of a deferred payment transaction to take into account the payments based upon a discount rate that is driven by the government's cost of money. These rules apply concepts to private transactions that are similar to concepts that are applied to publicly traded securities, such as zero coupon bonds. They impose a system of tax accounting for interest and principal payments that often may be different from the agreed upon interest and principal payments that the parties to a transaction themselves negotiate. Under the OID rules, payments of principal are recharacterized as interest, and, therefore, treated as income to a seller or lender if the stated interest rate falls below the statutory rate. Generally, the debtor-purchaser will receive a corresponding deduction.

Congress was concerned that under the law prior to DEFRA it was possible for taxpayers in a sale of nontraded property for nontraded debt to achieve "unwarranted" tax benefits either by mismatching interest income and deductions or by manipulating the principal amount of the debt, or both. Significant tax advantages could be achieved by characterizing a transaction as involving a lower rate of interest and a larger loan principal amount. If recognized for tax purposes, the mischaracterization of interest as principal resulted in an overstatement of the sales price and tax basis of the property. If the property was a capital asset in the hands of the seller, then the seller was able to convert interest income (that is, ordinary income) into capital gains taxable at preferential rates. Moreover, if the property was depreciable in the hands of the purchaser, the increased basis enabled the purchaser to claim larger cost recovery deductions. In the case of the sale of a new home where financing is provided by the builder, these incentives to disguise interest as principal for tax advantage are not present. The builder cannot report the profits on sale of the home as capital gain and an owner-occupant cannot depreciate the home.

In general, we do not quarrel with the principles that guided Congress in its deliberations over the OID rules. We do, however, think that Congress went too far in its attempt to close perceived abuses, and swept within DEFRA's net a multitude of legitimate, non-abusive transactions. For example, take the case of the typical home builder. The homes he sells are inventory, rather than capital assets in his hands. Thus, there is no incentive for the builder to understate interest since his gain is ordinary income, whether or not the payments he receives are characterized as interest. If the builder agrees to accept a moderate rate of interest, it is for the purpose of selling homes rather than an attempt to manipulate the tax system to his advantage.

I know of a builder who provides seller financing to his buyers for a relatively short period because he finds that, for psychological or economic reasons, home buyers resist paying interest above certain levels. The builder provides 10-year interest-only financing at a rate low enough to induce the buyer to purchase a home. The idea behind this type of financing is that once mortgage rates come down to a reasonable level, the buyer will refinance the loans. This situation does not involve any adverse tax gimmicks yet the builder is adversely affected. DEFRA would require the interest to be imputed at the 120 percent rate. The builder would be forced to accure the "deemed interest" over the 10 year period of the note, even though he receives no cash with which to pay the tax on that additional interest. We believe that it is inequitable to tax this type of seller before he receives the cash to pay the tax. This particular problem would not occur if the test interest rate was set at a reasonable level. Neither would this problem, occur if the OID exception for sales of principal residences applied to sales of new homes, as well as to resales of used homes. Because of high mortgage interest rates, the builder I have described must do what many individual home sellers must do, namely, carry some of the financing himself until the buyer can refinance elsewhere at a lower market rate. We feel that as a matter of equity the two types of sellers should be treated the same.

To summarize, in the situtation I just described, the builder currently reports the actual interest received from his buyer and the buyer deducts the interest when he pays it. Both of these events occur in the same year so that there is no mismatching of income and deductions. Nonetheless, the OID rules would convert part of the principal amount of the purchase price of the residence into additional imputed interest and force the builder to accrue that interest before the buyer pays it. Furthermore, as I noted previously, the home buyer is denied any deduction for the imputed interest that he is deemed to pay. If this type of transaction is to remain subject to the OID rules, we believe that the denial of this deduction to the home buyer is unwarranted.

Deferred payment sales of property (Code section 483)

DEFRA provided that, for sales closing after 1984, Code section 483 applies only to sales that specifically are excepted from the OID rules (for example, sales of principal residences, certain sales of farms, and other transactions involving total payments of $250,000 or less).

Furthermore, DEFRA revised Code section 483 a follows:

The interest rates and interest imputing calculations used in Code section 483 have been conformed to the new rates and imputing methods that I previously discussed used for obligations subject to the OID rules.

The new Code section 483 testing and imputing rates do not apply to sales of principal residences by individuals to the extent that the sales price does not exceed $250,000, nor to certain sales of farms. Rather, discount rates provided by old section 483 are used (9 percent test rate, 10 percent imputing rate), but both the test and imputing rates are compounded. (For the period January 1 through June 30, 1985, the 9-percent and 10-percent rates apply to loans with stated principal of up to $2,000,000.)

Stopgap legislation

The stopgap legislation (P.L. 98–612) provides that for sales or exchanges occurring from January 1, 1985 through June 30, 1985, the test interest rate is 9 percent and the imputing rate is 10 percent, to the extent that the stated principal amount of all debt obligations issued as part of the transaction (or a series of related transactions) do not exceed $2 million.

If the obligations issued in the transaction exceed $2 million, the test rate is a blend of 9 percent and 110 percent of the AFR. The imputing rate is a blend of 10 percent and 120 percent of the AFR.

We believe that the stopgap legislation is far better than the DEFRA rules it replaces. While we would hope to see permanent rules in place by July 1, 1985, if this is not possible, we would hope that the stopgap rules be extended for as long as it is necessary to work out a satisfactory solution.

II. IMPLICATIONS OF DEFRA OID AND IMPUTED INTEREST RULES

First, the DEFRA rules build high interest rates into most private deferred payment transactions. Instead of imposing a Federal rate when interest rates are fixed by the parties below a certain level, DEFRA requires that rates be established above the Treasury's cost of money at the time of the transaction. This ensures that negotiated private sales, except where exempt from the imputed interest rules, always will be at a rate higher than the Federal rate. Because the interest rate must be the rate that is in effect at the time the transaction is negotiated, this rate will vary. In a high interest environment, privately negotiated sales no longer will be a mechanism to bring down interest rates. Privately negotiated interest rates, instead, will follow the Federal Government's cost of funds.

This represents a major shift in philosophy. During the period of high interest rates in 1981 and 1982, private seller-financed sales in the real estate industry were a major way to continue real estate activity, even though public rates were at the 18 to 20 percent level. New home sales, sales of used homes, and sales of commercial and multifamily projects survived generally because sellers and buyers were willing to negotiate based upon interest rates that were well below the market. This provided a benefit to the nation's economy by keeping some new construction alive and by unlocking capital into the system.

Second, under current conditions, interest rates for seller-financed transactions will increase. Homebuilder-financed sales of individual homes involving total payments of principal and interest exceeding $250,000 fall within the new OID and imputed interest rules. Thus, in order to avoid the amortization of OID by both buyer and seller or the imputing of interest, a home builder must charge a rate of interest on an installment obligation issued by a buyer that is equal to, or greater than, 110 percent of the AFR. Since most home mortgages exceed 15 years, the AFR applicable to home builder-financed sales of homes generally will be the Federal long-term rate. For the month of April, 1985, the long-term AFR (computed on an annual basis) is 12.22 percent. 110 percent of 12.22 percent is 13.49 percent. Thus, a home builder would have to charge a rate of 13.49% in a seller-financed home sale in order to avoid the adverse consequences of the OID and imputed interest provisions. This high rate undoubtedly would dampen builder-financed sales of new homes. To continue further with this example, if the builder failed to provide for interest at least at the 13.49 percent rate, interest would be imputed at a rate of 14.75 percent. This, indeed, would be a high price to pay for the sales of new homes. I might add that the current VA interest rate is 12½ percent. Thus, a builder would have to pay a price for offering VA financing.

The underlying purpose of home builder-financed sales of homes when commercial interest rates reach a high level is to produce a negotiated interest rate that is lower than such rates. However, the new OID and Code section 483 imputed interest rules would impose an even higher rate in home builder-financed sales. It seems to us that this result undermines the entire concept of contractual terms and obligations freely negotiated at arm's-length.

Third, the new rules will increase interest rates that ultimately will be passed on to consumers. This will show up in many different ways. For example, multifamily projects will require a higher rate of interest when deferred payment transactions are entered into. The result will be an increased debt service burden for the project, thus, requiring higher rents to make the project feasible.

For purchasers of new homes, the effect will be an increase in the cost of those homes. This is because land sales often involve privately negotiated seller financing. The deferred payment provisions also will add significantly to the home builder's cost of development and construction of new homes. Typically, a builder will purchase raw land for the purposes of development and construction of housing tracts in an owner-financed installment transaction. The financing for such a transaction generally is fixed in the neighborhood of 10 to 12 percent.

The new OID and imputed interest rules will require an added interest cost that will have to be made up by the home builder in the price at which he sells newly-constructed homes. Accordingly, the new deferred payment rules well may drive up the price of new homes. Furthermore, the interest cost of carrying land during construction will increase. The end result is that builders, in order to maintain current project margins, will have to raise the cost of the final product to the consumer.

Fourth, the new rules will virtually eliminate investment in low-income housing. The housing stock for low-income renters will be forced to decline gradually because many HUD low-income projects do not have adequate reserves for repairs and maintenance. One of the major benefits of the Economic Recovery Tax Act of 1981 was the infusion of capital into low-income projects and the attraction of new investors. These investors were seeking tax benefits associated with real estate investment and were willing to place new capital into projects that were badly in need of refurbishing. The HUD guidelines required additional repairs, maintenance, and higher levels of reserves. Because the income from these projects was not adequate to support the debt service, the transaction often involved negotiated agreements between buyers and sellers for low interest purchase money loans in which the final payments of interest would not be made until sometime in the future. This resulted in cash flow to support the debt service.

The OID rules, which will reduce the principal for purposes of cost recovery deductions and require sellers to recognize phantom income, will mean that these types of transactions no longer will be attractive to investors. The result will be that many HUD properties will continue to decline and HUD may often have a higher inventory that will be very costly to maintain and operate.

NAHB urges the Committee to consider these problems very carefully as part of the potential OID revisions. In addition, we urge the Committee to investigate with HUD the implications of the new OID rules for the existing HUD assisted housing stock.

III. NAHB POSITIONS AND CONCLUSIONS

The DEFRA provisions with regard to OID and imputed interest have created major problems both from a technical and a policy viewpoint. As I noted earlier, the provisions build high interest rates into privately negotiated transactions. Thus, NAHB believes that Congress should reconsider the entire issue. Ideally, NAHB would prefer that the DEFRA OID and imputed interest provisions be repealed, and we appreciate the efforts that Representative Archer and others have made in that regard. Although short of repeal, we also are encouraged by the efforts of Representative Matsui and others on the Committee to find a workable solution to the problem, and commend them for their action.

At a minimum, we believe that a more realistically designed provision should be enacted. The test for imputed interest rates is too high. We feel that the test rate should be set no higher than 80 percent of the AFR and the imputed rate should be set no higher than 100 percent of the AFR. Furthermore, a cap should be placed upon the upward escalation of the imputed interest rate. We feel that a cap of 12 percent would be appropriate.

We feel that it would be appropriate for the Committee to retain the threshold concept, as embodied in the stopgap legislation. However, we suggest that a higher threshold ($4 million) be adopted. We feel that a higher threshold is appropriate both for the purpose of accommodating larger projects and in the interest of simplification. Furthermore, we believe that if a permanent threshold is adopted, the legislation and committee reports should make it clear that the threshold amount applies, in the case of a home builder, to each separate residence, cooperative, or condominium unit sold to a separate buyer. This would clarify that sales by a home builder of all the houses in a single development, or of all the cooperative or condominium units in a single building, to persons who are unrelated to one another are not to be aggregated.

We also feel that assumptions of loans, whenever they originated, should be excluded from the OID and imputed interest rules, unless the assumed loans are substantially modified. Neither the buyer nor the seller have any control over the interest rate provided for in an assumed loan.

Furthermore, we believe that more consideration should be given toward targetting OID and imputed interest rules to transactions that the Congress perceives to be truly abusive (that is, to transactions that are driven purely by tax considerations with little, if any, economic rationale). As I pointed out earlier, for example, we do not believe that sales of homes by home builders are the type of transactions that the Congress perceived to be abusive. In fact, it would appear that all nondepreciable property could be excluded from the OID rules without violating the concepts that motivated the Congress in enacting DEFRA. Several technical, problems that we have not discussed in the interest of time (for example, contingent and viable interest rate loans) would disappear if the Congress settled upon a reasonable safe-harbor interest rate.

Finally, we believe that the issues of OID and imputed interest should be kept separate from the issue of builder bonds. One of the early compromise proposals in the Senate last year did deal with builder bonds. Appropriately, the builder bond question was not included in the stopgap legislation. Since the two issues deal with separate problems, we feel that it is appropriate for Congress to consider them separately.

Thank you for the opportunity to present our views. I would be happy to answer any questions you may have, and I look forward to working with the Congress to fashion appropriate OID and imputed interest rules.

Mr. MATSUI [presiding]. Thank you, Mr. Smith. At this time, we have a vote. We have 10 minutes to get to the floor of the House to vote. We will take a recess until 12:25 and then we will proceed again with Mr. Sherman.

[A short recess was taken.]

Mr. MATSUI. At this time, we will reconvene the hearing on imputed interest. At this time I would like to call Mr. Robert Sherman from the National Apartment Association.

STATEMENT OF ROBERT F. SHERMAN, PRESIDENT-ELECT, NATIONAL APARTMENT ASSOCIATION

Mr. SHERMAN. Thank you, Mr. Chairman and members of the committee.

My name is Robert Sherman. I am president of S&S Properties, Inc., a real estate development and management company located in Dallas, TX. I am also president-elect of the National Apartment Association on whose behalf I am appearing today.

NAA represents the interests of the multifamily housing industry. We have approximately 33,000 member companies who are in the multihousing industry. Rather than cover the same material as the previous witnesses, let me address several key points that I think are important and give two examples as well.

I think it is important that the committee recognize seller financing is an essential tool in our industry. Banks, thrifts and other lending institutions are not willing to finance every transaction.

Many times, seller financing is the only way to make a sale. The key to resolution of this issue is the interest rate. We are suffering under an unfair burden of having unduly high rates forced upon us. The minimum midterm rate for seller financed transactions exceeds the VA rate for a 30-year fixed rate mortgage.

The appropriate rate for seller financing should be based on a seller's cost of funds, most appropriately measured by what the seller could otherwise do with those proceeds. Most sellers would consider the rate which could be earned on a certificate of deposit a reasonable alternative, and would use that rate as a guideline.

The rate set at 110 percent of AFR is just too high. Eighty percent of the AFR would produce a more reasonable rate. It would approximate the CD rate.

Not only should the rate be reasonable; it should also be stable. The National Apartment Association recommends that Congress consider the Federal Home Loan Bank cost of funds ratio as an index because it is less volatile than T-Bill rates. It is available monthly and it does reflect the cost of funds to thrift institutions who are primary lenders to the real estate industry.

The Tax Reform Act of 1984, which was followed by a temporary stopgap law, needs clarification and modification regarding transactions involving wraparound financing.

The NAA strongly believes that the rules should apply only the to new seller financing portion of a wraparound loan. Preexisting financing and loans from third parties should not be subject to the OID or imputed interest rules as long as the terms of the preexisting debt are not modified in such a way as to benefit a seller and the preexisting loans were in compliance when originally made.

I have a specific example in Houston, TX, on a property that we sold. And when I applied the OID rules and the imputed interest rules to that sale, I wound up charging over 28 percent on the effective seller portion of my financing, a rate that would be usurious in the State of Texas.

The committee should also understand that most rehabilitation on properties occurs when the property is sold and transferred. To the extent there are fewer transfers, less work will be done to rehabilitate and preserve the existing housing stock. Further, funds that would have been spent on rehabilitation when a property is purchased will now be used for interest payments.

Again, to cite the extreme example which Houston, TX, represents, we were considering selling a property at this point in time by which we would be willing to defer interest for the first year. During that period of time, the purchaser will first make capital improvements to the property and, second, pay negative cash flows that currently exist.

Beginning in the second year, we would be paid interest if it were available from the operations of the property, and in the third year, interest would be payable to us.

As a seller, I am highly motivated to be a party to this type of transaction not by some kind of perversion to the tax law, but, in fact, to have someone step in and pay negative cash flows to make capital improvements to the property. In addition, by being able to make the sale, I am able to avoid potential bankruptcy of that partnership and foreclosure of the property.

Mr. Chairman, this Committee has succeeded in removing the possible abuses in this area by prohibiting the mismatching of interest expense and interest income by the application of the OID rules to the real estate transactions.

The Tax Reform Act of 1984 established penalties for under reporting tax liability through over evaluation of property. However, we believe that Congress went too far in requiring unreasonable rates of interest and transactions where the AFR is just not applicable.

The NAA urges Congress to play a less intrusive role in setting interest rates in real estate transactions. A reasonable rate would prevent abuses, but not dictate the terms of the contract.

Due to the variables in real estate investment, Congress cannot pour all transactions into one mold. The NAA believes that either a rate of 80 percent of the AFR or the Federal Home Loan Bank Board cost of funds ratio would be a reasonable level.

Thank you for the opportunity to present our views. I would be glad to answer any questions you may have.

[The prepared statement follows:]

STATEMENT OF ROBERT F. SHERMAN, PRESIDENT-ELECT, NATIONAL APARTMENT ASSOCIATION

My name is Robert Sherman. I am President of S&S Properties, Inc., a real estate development and management company located in Dallas, Texas. I am also President-Elect of the National Apartment Association[1] (NAA) on whose behalf I am appearing today.

The NAA represents the interests of the multifamily rental industry. The OID/imputed interest rules affect our industry in several ways. They affect the way property is sold, the extent rehabilitation work takes place, and the rent levels which we can charge our residents. Our industry is unique because, unlike many others, our clientele consists almost entirely of low- and moderate-income households. In 1983, the median income of these renters was $13,400 and approximately 30 percent of their income was devoted to rent. There are approximately 30 million renter households in America.

In the rental housing industry, increased costs cannot be easily passed on to the ultimate consumer because they cannot afford it. Further, the consumer demand for our product is inelastic. There is no choice to "go without" when it comes to housing. Our goal, and a goal of society, is to provide housing at an affordable price.

The Tax Reform Act of 1984 extended the OID and imputed interest rules to real estate transactions. These rules require parties to a seller financed transaction to lend at certain "safe harbor" interest rates. If the parties fail to meet the safe harbor test of 110 percent of the applicable federal rate (AFR), then for tax purposes an interest rate of 120 percent of the AFR would be imputed. The value of the property would be recalculated as if the imputed rate was the effective interest rate. Interest income would also be imputed to the seller/borrower at the imputed rate, even though it exceeds the interest received. This unreceived yet taxable interest income is called "phantom income."

Very few seller/lenders are willing to be taxed on phantom income. Interest rates on seller financed real estate transactions are now higher and there is no deferral of any part of the interest payment. The application of these rules to real estate has had the effect of requiring greater cash flows from the property. Funds that would have been spent on rehabilitation when the property is sold will now go to interest payments.

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[1] The NAA is a trade association that represents the interests of the multifamily rental industry. We have approximately 33,000 members who are owners, managers, builders and developers of apartment and condominium units. Our members represent more than three million apartment units.

The OID and imputed interest rules represent a response to perceived abuses of prior law that enabled the parties to overstate the principal element of a transaction and to take advantage of the ability to mismatch the deductions claimed by the purchasers of property and the reporting of income by the Seller. In certain cases, low interest rates have been a vehicle to shift ordinary gain to capital gain, and to increase the depreciable basis of the property. However, those cases are overshadowed by the normal operations in commercial real estate where interest rates move far slower and less dramatically than money market rates. We urge Congress to adopt a reasonable set of rules that do not unduly burden seller-financed transactions.

Mr. Chairman, we believe this Committee did succeed in ending the perceived abuses in this area by prohibiting the mismatching of interest expense and interest income by the application of the OID rules to real estate transactions. However, we believe the Congress went too far in requiring unreasonable rates of interest in transactions where the AFR is just not applicable.

Therefore, further restrictions to control the alleged abuses wherein income was shifted from ordinary to capital gains are unnecessary. The Tax Reform Act of 1984 also instituted penalties for the underreporting of tax liability due to overvaluation of property (IRC Section 6659). We believe this penalty as well as other tax shelter reporting requirements will curb abuses that involve the shifting of income that may lead to overvaluation.

The Congress must make a policy decision as to the degree of the government's role in regulating business transactions. Congress must choose between making laws that prevent abuses, or laws that regulate and restructure every transaction to suit a certain model transaction. To establish interest rates and thereby restructure transactions is beyond the proper function of the tax code, particularly when the value of the investment is affected by factors that are not related to the interest rate.

The tax code must be practically administrable and conform to the reasonable expectations of persons engaged in everyday transactions. There are many provisions in the tax code that reflect the understanding that pure tax and economic theory does not always make good tax law. Some of these provisions are: such as permitting the use of the cash method of accounting, not taxing the imputed income of owner-occupied residences, and non-taxation of certain in-kind fringe benefits. The sale of residential real estate is an area where it is important that the tax law apply in a manner that meets the parties' reasonable business expectations. The innovative nature of business should not be hamstrung and forced to comply with certain models.

Those who advocate very strict OID/imputed interest rules would have Congress believe that every seller-financed transaction is entered into for the purpose of tax avoidance. This point of view fails to understand or address the business relationship between the parties, the nature of the investment and the real estate industry.

Mr. Chairman, the Committee must recognize that seller/financing is an essential tool in our industry. Banks, thrifts, and other lending institutions are not willing to finance every transaction. Many times seller/financing is the only way an individual can make the sale. This is especially true for rental housing that needs substantial rehabilitation. Otherwise an owner, who may not have the financial ability to keep up the value of the property, may not be able to sell the property. The problem of liquidity of the asset is aggravated if the seller cannot assist the sale.

The strict application of the OID/imputed interest rules to investments in real estate incorrectly presumes that the value of real estate is determined by interest rates alone. An investment in real estate is not the same as an investment in a fixed rate bond. There is no guaranteed fixed rate of return, nor is there a fixed term. Where the price of a bond will drop as interest rates rise, the value of real estate, especially residential rental real estate, does not automatically move as interest rates move. Real estate values are subject to many forces (rent control, zoning, demographics, liquidity), in addition to interest rate fluctuations.

For example, the value of an apartment building will decline the moment a city institutes rent control because the ability to raise rents and the income stream will be limited. This will happen even if interest rates decline. Therefore, it is not proper to calculate the value of real estate by using a high interest rate as the single factor. To the extent real estate values are affected by factors other than interest rates, the use of interest rates as a factor in calculating the value should be reduced.

INTEREST RATE LEVEL

The interest rate level which must be charged is the key to the resolution of this issue. The higher the rate, the more exceptions the legislation will have, thereby making it complicated. The attached graphs compare institutional mortgage rates versus their cost of funds. Today, the prime rate is 10.5 percent. The Veterans Administration (VA) rate on a 30-year fixed rate mortgage loan is 12.5 percent. Yet, the mid-term safe harbor rate for May is 13.05 percent calculated under the alternate method, Temporary Treasury Regulation (1.1274- -6T) and 14.75 percent when calculated under the six month formula in the law. We are suffering under an unfair burden of having higher rates forced upon us. As a general rule, lending institutions must charge mortgage interest rates that are two to three and one half percentage points above their cost of funds These rates are charged by lending institutions in order to cover overhead expenses and defaults, provide other services to their customers, and show a profit to their owners and shareholders.

Generally, sellers of property do not have these obligations and are much more familiar with the true value and potential of the collateral than a third party lender. Therefore, they do not have to charge the same high interest rates. A seller who makes a loan to liquidate his investment compares the loan rate with the return he could get with that money, such as the rate on a certificate of deposit (CD). To force seller financing rates up to institutional lending levels is unrealistic and based on the false presumption that institutional lenders are the only market setters. The interest rate level which sellers must charge must be lowered.

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Not only should the rate be reasonable and represent an interest level that accommodates the needs of the parties, but it should be pegged to a less volatile index than Treasury securities. The graph on page nine shows the various T-bill indices over time. They fluctuate with the money markets on a daily basis. The T-bill rates are subject to influences that are not related to the real estate market. T-bill rates are sensitive to domestic and international politics; gold, oil and other commodity prices; worldwide monetary exchange rates, as well as our own stock and bond markets.

We recognize that the AFR is used in other sections of the tax code. However, it should not dictate that it be used in all cases; especially when there is a better index.

The NAA recommends that Congress consider the Federal Home Loan Bank Cost of Funds Ratio as an index. The Cost of Funds Ratio is the weighted average rate at which thrift institutions borrow. It includes interest which thrifts pay on CDs, savings accounts and their borrowings from the Federal Home Loan Bank. We believe using the of Funds Ratio as an index has several advantages. It is less volatile than the T-bill rates. It also represents the wholesale cost of money to thrift institutions. The Cost of Funds Ratio is made up of interest payments that thrifts pay on savings accounts and CD's to their customers. As stated earlier, sellers will consider the alternate use of the money when negotiating seller-financing.

The Cost of Funds Ratio is also real estate related. Thrift institutions play a large role in real estate mortgage lending. Because of these features the Cost of Funds Ratio may be more appropriate as an index.

CALCULATION OF THE AFR

The law provides a formula for calculating the AFR by using an average rate of T-bills over a period of time. However, we have found that by using this formula, the AFR does not represent true market conditions. It takes the average T-bill rate from April to September of 1984 to arrive at the AFR for January through June of 1985. In other words, the safe harbor rate incorporates factors that are 3 to 15 months late. As rates dropped in 1985, the safe harbor rate (based on lagging higher rates) was higher than bank rates. In response, Treasury issued rules that created a monthly AFR which had only a one-month lag time.

The ability to elect the lowest safe harbor rate has a beneficial effect and we seek to preserve the election. By being able to select a current rate or a lagging rate, we will be able to avoid the spikes in interest rates. As rates go down the monthly rate would be more favorable. As rates increase, the ability to use a rate that was calculated during a more reasonable interest rate climate would be more favorable. The ability to avoid some of the fluctuations of the market is essential.

Mr. Chairman, whether the rate level is calculated using T-bills or the Cost of Funds Ratio, the Committee must provide some leeway in setting the rate in order to allow parties to customize transactions that will accommodate their needs and circumstances. Congress should not be in the business of setting interest rates for private transactions. Congress' goal should be to set a reasonable minimum rate that prevents abuses of the tax code. We believe that a rate that approximates the CD rate which is about 80 percent of the AFR is a reasonable level.

ASSUMPTIONS AND WRAP-AROUND FINANCING

The Tax Reform Act of 1984, which was followed by stopgap legislation (P.L. 98-612), left some confusion as to the status of transactions that involve assumptions, wrap-around financing, and the taking of property subject to a loan. The confusion centers around whether the amount of the pre-existing financing should be aggregated with the new seller-financing to reach the $2 million threshold when wrap-around financing is used. A wrap-around loan is the incorporation of pre-existing debt into a single larger loan with some new financing.

It is NAA's position that the rules should apply ony to the new seller financing portion of a wrap-around loan. Pre-existing financing and loans from third parties should not be subject to the OID or imputed interest rules, as long as that loan was in compliance when it was originally made. We also believe that such prior loans, or third party loans should not be included in reaching the threshold level.

Let me give you an example of a recent negotiation that I was involved in wherein the transaction was lost because of the new OID/imputed interest rules. The sale price was to be $10 million; $2 million down payment and $8 million financed. $5.4 million of pre-existing financing at 8.5 percent was to be wrapped with an additional $2.6 million second trust. Under the current interpretation of the law, the entire $8 million was considered new financing and subject to the OID/imputed interest rules. To bring the blended interest rate on the entire $8 million to the required level, I would have had to charge 28% interest on the $2.6 million.

To accommodate this high interest rate, my adjusted value would have been $1.5 million less. The deal would not work at an $8.5 million sale price.

The fact that a property has financing that is assumable is an asset that is an inseparable part of that property. The purchaser who commits to a long-term interest rate pays for that rate as well as the assumability feature. To penalize that owner for obtaining financing that was at the market rate at the time it was incurred is not proper. The new seller financing should be the only amount subject to the new rules.

In defining what an assumed loan is, Congress should recognize that lenders will normally impose additional restrictions on the new borrower(s) when a loan is assumed. The restrictions might include a shortening of the term of a balloon loan, requiring the payment of additional points upon a subsequent assumption, the prohibition of subsequent assumptions, or the pledging of additional security. The essential terms of the loan remain unchanged. The alterations are usually to the borrower's disadvantage and do not have significant tax consequences. A strict requirement that the terms of an assumed loan remain completely unchanged is not realistic. The NAA urges that a substantial economic or substantial tax impact test be applied.

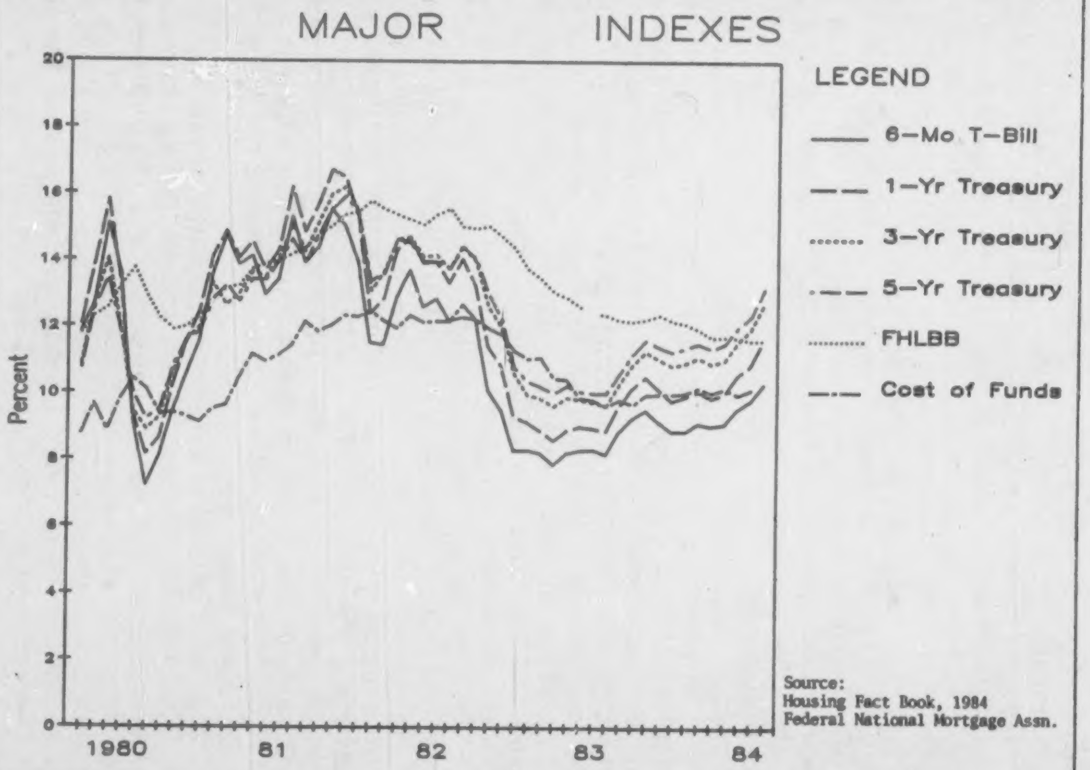
THRESHOLD AMOUNT

Current law provides a $2 million threshold level to distinguish between small and large sized transactions. A rough average per unit purchase price of a multifamily building is $30,000. The $2 million threshold would apply to a property with only 66 apartment units. The NAA favors a higher threshold amount to protect the small and medium sized transactions from the full impact of the legislation.

The law exempts single family homes with sale prices of up to $250,000. At the same time it applies to multifamily apartment buildings where the units may be worth only $30,000 apiece. The fact that a multifamily project is providing housing for 66 families under very modest circumstances is ignored.

Again, I emphasize that the goal of good tax laws should be to let business go about its business while preventing abuses of the system. The law must recognize the business realities that exist.

The NAA urges Congress to play a less intrusive role in setting interest rates. A reasonable rate would prevent abuses, but not dictate the terms of a contract. Investments in real estate are not investments in fixed interest rate instruments. Due to all of the variables involved in real estate, Congress cannot pour all transactions into one mold. The NAA believes that a rate of 80 percent of the AFR is a reasonable level. Thank you for hearing our views. I would be glad to answer any questions you may have.



Source:
Housing Fact Book, 1984
Federal National Mortgage Assn.

Mr. MATSUI. Thank you very much, gentlemen.

I would like at this time to call on Mr. Duncan.

Mr. Duncan.

Mr. DUNCAN. Thank you, Mr. Chairman.

I want to thank the panel. It has been a very good panel. I think most of you were in the room when Treasury testified this morning. Would any of you care to respond to anything Treasury had to say when they testified this morning, awhile ago?

Mr. DRIESLER. Mr. Duncan, I responded briefly to one example that Mr. Pearlman articulated, and that was a $10 million loan at 30 years at 80 percent of the applicable Federal rate, at which point the Treasury estimates there would be a 30-percent overevaluation of basis.

Where our industry is concerned, and I think where the Congress ought to be concerned is identifying potential areas of abuse. And the simple fact is, and I think the committee ought to request from the joint committee or the Department of Treasury estimates on inflated value when you are talking about 80 percent of the applicable Federal rate for 5, 7, 10 years. Those are the terms that we usually talk about in seller financing in the multihousing industry, and you will find that the inflation of basis under those circumstances is nonexistent. You may talk about a 5- or 10-percent theoretical overevaluation, but, gentlemen, I tell you to take two appraisers and go out and appraise a $10 million apartment building, there will be a 5- to 10-percent difference in their opinion of what that building is worth. So, for all intents and purposes, you adequately state the value of the building, the basis of the building, and you adequately characterize ordinary income to the seller and capital gains to the buyer in that circumstance which is not abusive and ought not to be subject to these complex rules.

Mr. DUNCAN. Thank you.

Mr. Wallace, I believe you wanted to respond there.

Mr. WALLACE. Mr. Duncan, thank you for asking the question. I think my response will be more generic. I get the impression, with all due respect to Treasury, that they are looking as if the American public is out there conniving to do them in and the tax abuse is the reason for these rules. I think we believe that the average buyer and seller in a down market has virtually no place to turn.

And if this committee, this Congress, in effect, precludes us, as Treasury 1984 did, in this area, from turning to the only vehicle that may be available to some poor devil moving from my hometown in California to Tennessee, I do not think that is the intent of Congress, certainly, and it is not the intent of people out there. For the most part, with few exceptions, and there were abuses, and I think we are trying to address those abuses here, the average buyer and seller in a down market, which is when this is most needed, just wants to make the transaction happen. I think Mr. Archer or some of the other committee members mentioned prices come down. We, as realtors, give advice to people that do a lot more intensive marketing effort under those circumstances and one of the obvious questions that we ask when we are taking a listing, "At these times you may, Mr. Seller, have to help finance the buyer." And the seller is a great vehicle because he does not have the overhead and all of the cost of funds that the institutions do, so he can afford to finance a transaction in those circumstances. But nothing that we do here should interfere with the free market doing its normal thing, I think, and focus only on those, in my estimation, very limited areas of abuse.

Mr. ARCHER. Would the gentleman yield?

Mr. DUNCAN. I would be glad to yield to the gentleman from Texas.

Mr. ARCHER. I just wanted to follow up on Mr. Wallace's comments and also Mr. Sherman's too.

Would you then take the position that there is not—I would like to get the response for the record because it relates to what the Treasury said—that there is not eschewing of the transaction, whether intentional or not, and a lot of times the Treasury will say, "We are not really saying everybody is deliberately trying to do something to get a tax advantage," but, the reality, they say, is that by charging a lower interest rate that you have a higher price on the property.

That is their contention.

And, by having a higher price on the property, instead of letting it have to come down in the marketplace by charging a higher interest rate, you, in effect, create greater depreciation. You convert ordinary income into capital gain and you create greater depreciation on the other side. Now, that is their allegation. I mean obviously from a position that I have taken, I am in sympathy with your comments, but I would like to get your response to that in the record, if we could.

Mr. WALLACE. Mr. Archer, we appreciate your understanding over the last year or so in helping us in this regard. I would venture that in 99, or 98 percent of the transactions, the allegations that Treasury puts forth are just nonexistent, intentioned or otherwise. It just does not occur. There probably are a few transactions, some transactions whereby tax avoidance is at issue. But, for the average transaction throughout the length and breadth of the country, it just is not at issue. Sellers in a declining market, virtually high interest rates, virtually no institutional funds available, the market is coming to a screeching halt. 1982 was my example. I am happy to still be here, to have survived that, and my membership feels the same way.

You should see the statistics that we carry nationwide. Prices did come down; seller financing went up in my home State to about 60 percent. I mean I gave you a 34-percent figure for residential, and 41 percent for farms, but I tell you in some pockets, high cost of living areas, northern Virginia here and other, it is the only salvation you have between some poor seller getting on where he has got to go, transferred, and some buyer being encouraged to help him do so. So I could not agree more.

Mr. DUNCAN. I tend to, of course, favor repeal, but it has been suggested if we gave preferences to smaller transactions, say less than $1 to $4 million it might eliminate most of your concerns.

Would one of you care to respond to that?

Mr. WALLACE. I do not think $1 million would do it, frankly. But we are in support, as I indicate, of Matsui's bill at $4 million. And the reason is not only because of the residential differences throughout the country. In some areas, $1 million——

Mr. DUNCAN. But $4 million would take care of your concern?

Mr. WALLACE. Four would take care of us, and it also takes care of the Mom and Pop transactions in the investment area.

Mr. DUNCAN. What about you, Steve, would it take care of yours?

Mr. DRIESLER. Mr. Duncan, the important thing to my members, because we are larger apartment developers, $1 million or $4 million, quite frankly, does not make a whole lot of difference. The important thing is the test rate that you apply to those transactions beyond the threshold. If that test rate is fair and reasonable, it does not matter, $1 or $4 million; it really, simply, does not matter.

Mr. DUNCAN. Thank you, Mr. Chairman.

Mr. SMITH. Mr. Duncan, in response to a question that you asked earlier, I think the important thing this morning was that you all asked for information about where Treasury came up with the $1.8 million revenue loss figure. Now, we have asked for the same information, and we have not gotten the facts. Recently, we asked Secretary Baker for the same type of information. I think it is unfair to ask the industry or the public to accept something when, in fact, Treasury does not have the backup for the numbers they are using. It seems to me that Congress should not be adopting policies to increase interest rates—it should be adopting policies to lower interest rates, and not to set floors on interest rates in this country. That is what this law would do. It would set a floor on some of the interest rates. So we should be turning to the other efforts.

Mr. DUNCAN. Thank you.

I would like to thank the panel again. My time is up and has been up.

Mr. MATSUI. Mr. Archer.

Mr. ARCHER. I just wanted to see if Mr. Sherman had some response to the question I asked about the value of the property. In effect, as a result, the Treasury says, and they do not claim it is tax avoidance in many instances, but the result of it is, they say, it reduces revenue that would come from these transactions, and I would like to have your comments on that too.

Mr. SHERMAN. Thank you, Mr. Archer; I appreciate it.

I think Treasury implies, first, that the transactions seem to be interest rate-driven, and that clearly is not the case. There are many factors involved in transactions beyond interest rates which affects the value someone will pay for a property.

Second, we do operate in one of the most free market conditions ever, dealing with willing buyers and willing sellers who work together to establish purchase price. And I think it is fallacious to think that a purchaser would pay an exorbitantly high price in order to satisfy the needs of the seller when he knows that a major part of his profit is going to be a sale at the other end. Therefore, he has got to buy at a price in which he knows he can make economic sense and justify a sale down the line.

Mr. ARCHER. Well, to be a devil's advocate, let me respond in the way the Treasury responds to me when I say that. They say yes, but the purchaser gets to accelerate his depreciation and his tax writeoffs by having a higher value and, therefore, the purchaser gets the benefit. It is not the seller; the purchaser gets the benefit out of it too.

Mr. Sherman. Yes, sir, I understand the purchaser will benefit by the higher basis that comes along and, yet, he has got to have a profit motive. I mean one presumes one buys property for a profit motive, and I presume that the profit, a major portion of the profit, will come in the appreciation of the value of that asset. He cannot afford to overbuy significantly at the start, is my point.

Mr. Archer. They would then say that he also helps himself because he takes an ordinary loss on the depreciation and a capital gain on the ultimate sale and, therefore, from a net dollar in his pocket standpoint, he benefits.

Would you like to respond to that?

Mr. Sherman. I think that was the way the tax laws were established at this point in time. But, I think the deals are made between willing buyers and sellers for other than just interest rate factors in mind.

Mr. Archer. I dislike putting myself in the position of responding as the Treasury responds to me. I wish the Treasury could be here and we could have an interchange with you while they are here, but I want to get some of this into the record, and I appreciate your responses.

Mr. Smith. I could not help but sit back and think, when Treasury talks about lowering property values, what is going to happen to the thrift industry in this country if you start lowering the value of properties on which they made loans. We have enough problems with the thrift industry right now, much less having a devaluation of property values across this country.

Mr. Archer. I appreciate those comments. I have also commented to them on several occasions that if they do—if what they say is true, and there will be a significant reduction in the value of property out there, what they do to the tax base of many of our cities and school districts, which I do not think would be a very desirable result, at the time when we, as a government, and I think appropriately, are saying that State and local governments need to pick up a bigger share of the load.

Mr. Wallace. Mr. Archer, also, the argument the Treasury—that you are advancing, devil's advocate on behalf of Treasury, on basis and capital gains and so on, there is no water in residences and farmland and, yet, they have given us virtually uniform rules in 1984 to deal across the board. So there are some built-in terrible inequities and it needs to be shaken out.

Mr. Matsui. Thank you, Mr. Archer.

I would like to ask you gentlemen a question.

Mr. Pearlman indicated that he wanted to go with the accrual method of accounting. And the proposal that I advanced last week would give the alternative, either cash or accrual method of accounting, depending upon an agreement between both seller and buyer, so it would be either cash-cash, accrual-accrual. And there would be no revenue loss to Treasury.

How important is that to your respective industries if we went with Mr. Pearlman's approach rather than the approach of giving the option?

Mr. Driesler. Mr. Matsui, it is very important for multifamily housing, particularly lower income multifamily housing, because often the cash flow from those projects simply will not support current interest payment. It is therefore necessary to defer all or a portion of that interest payment until the time that you either sell the property, refinance the property and/or that the buyer can meet those payments. Now, if you are forced into an accrual-accrual or OID method, then the seller is going to be faced with phantom income. He is going to be taxed for money he does not receive, whereas, if both buyer and seller on the cash method, you have eliminated the mismatching problem, there is no revenue impact to the Treasury, there is no abuse, why should that not be a legitimate transaction?

Mr. WALLACE. We would agree, Mr. Matsui that that is covered in your bill and takes care of the potential abuse. And I heard Mr. Pearlman saying, "Well, it's those downstream side effects to charitable institutions," and he struggled after that. I have got to tell you that most of these carry-back financing, at least in the market in which I deal, small business investment and residential, certainly, the carry-back noteholder does not rush right out hypothecated. He is again focusing on some very narrow perameters of alleged, I think, ivory tower thinking abuse. And it just is not the real world. It does not work that way except in rare instances.

So your bill takes care of them.

Mr. SHERMAN. I agree.

Mr. MATSUI. We agree also.

In terms of Mr. Pearlman's testimony, he has indicated that he did not like the notion of a blended rate, but would prefer dealing with a cliff because of the complexities of a blended rate. And he referred specifically to your various industries saying that your industries would not like it because it would be too complex in terms of the transactions that would occur.

May I have your thoughts on that? Is it complex? Is he correct in that analysis or incorrect?

Mr. DRIESLER. He is incorrect. We would desire a blended rate. If you have a threshold of whatever amount and of the rate below that threshold is at a different interest rate than above it, we would want a blended rate.

Mr. WALLACE. On the one hand, he is advocating complexity by tying it to some index and, on the other hand, he is saying it is too complex, so let us have a cliff.

I would tell you the farmers in his bill at 1 million 1 dollar would not enjoy the cliff. So I suggest that that is not real world thinking either; that the blended rate appropriately tied in with these other factors is an absolute must.

Mr. SHERMAN. Mr. Chairman, I would agree with that. The blended rate is extremely important in multifamily housing where we are trying to provide housing to low- and moderate-income people. Even a floor of $4 million provides coverage, basically, at a $30,000 per unit cost to a little over 130 units. And, basically, that does not give much of an exemption. It is extremely important to multifamily housing.

Mr. MATSUI. Mr. Smith.

From a conceptual point of view, I think the question that Mr. Pease was asking and also Mr. Archer was asking, in terms of the seller financing mechanism where you do not have the traditional lender involvement, I believe Mr. Pearlman made an issue out of that in his opening remarks that because there is no intervening third party, so to speak, that is, the traditional lender, it leaves opportunities for manipulation of the Tax Code, but it has been my understanding, and I would like you either to affirm or disaffirm this, in most cases, in seller financing, the seller financing his own transaction, you find an unwilling seller or unwilling financer in that situation. It usually occurs when interest rates are extremely high or the financial markets are extremely volatile, and money is very tight. And I find that in most cases the seller really is not interested in being part of that financing scheme but, in order to keep the economy going in a time of recession or high interest rates, he must engage in that transaction. And usually it is short-term financing. So the problem of conversion of capital gains or ordinary income may be minimized because I cannot imagine any seller wanting to go 15 years, 20 years or 30 years because they eventually hope that the economy will stabilize.

May I have your thoughts on that? Because that seems to be a major issue as to why we are involved in this issue anyway, and I would like to get your thoughts in that regard.

Mr. **Smith**. Well, certainly, our thinking would be that seller financing occurs when the interest rates are high. In many cases, you have older folks who want to move to different locations, retire and so forth, and the only reason they finance the sale of their property—they really do not want to take back financing—is simply to sell their homes. I think the tax consequences are the last thing that they are really concerned about. What they are really concerned about is getting their home sold so they can retire and move to another community.

Mr. **Wallace**. Seller financing, Mr. Chairman, is this financing of last resort. It is almost never a first choice. It is only because there is not anything else of an affordable nature that is available to the seller. So he does it as an accommodation and he has probably at the same time lowered his price as well.

Mr. **Driesler**. I would like to echo the comments of the two previous speakers and then add one additional comment concerning Treasury's analysis on assumptions.

First, Mr. Pearlman takes the position, as you correctly point out, Mr. Matsui, that if there is a third party lender out there, these transactions are not subject to abuse. But then Treasury comes back 15 minutes later and argues, if somebody goes out and assumes this existing third party debt, they do not want the new purchaser to assume it because there is some potential out there for abuse. With third party financing, they are an arms length transaction, it is not an abusive situation when it originally occurred, it ought not be subject to these OID-imputed interest rules thereafter. If it is a problem, which Treasury contends it is not, then we ought to address it the first time around. They cannot have it both ways.

Mr. **Sherman**. I think when a seller goes into it he recognizes he is dealing basically with a piece of paper, and despite the fact it may be discountable, we have seen that the discount rate applied when a seller tries to sell the note is exorbitant, and he gets very little actual proceeds for the money he lent. I think a seller wants to use that money. Recognizing that, he wants, therefore, to go short term with as little seller financing as possible.

Mr. MATSUI. Thank you.

Gentlemen, I would be remiss if I did not ask this question, or at least ask you all to think about it. We just dealt, 3 weeks ago, I believe it was, with the issue of recordkeeping on automobiles. It is an explosive issue. We heard from every one of our constituents and we came up with a proposal, at least on the House side, and, in coming up with that proposal that we think we have satisfied the American public with respect to, we came up with alternative revenues. And, if you will recall sitting through this session in the morning, the chairman indicated that the deficit issue is a major issue, and he happens to have on his desk, and when I came up here I noticed it, a copy of the Washington Post in which the National Association of Realtors, Mr. Clark, talks about the need to deal with the deficit issue. And I think we all agree with that. Assuming that when we come up with a solution of the whole issue of imputed interest, that we have to come up with some revenues to offset that. Now, maybe it would not be 100 percent, but at least some revenues to offset it. I am not speaking for the Senate. I am only speaking for the House. The Senate, in their recordkeeping changes, did not come up with revenues to offset that.

I hope that you will consider and think about alternatives to deal with in order to satisfy those that might need alternative revenues as we move through this process.

The impression I get is that everybody feels that we have to make some changes, because it is essential to the industry. If those changes are made, we may have to then also deal with the issue of revenues. I am asking that in good faith, and bringing it up because I think it has to be discussed in the context of solving this problem.

Mr. Wallace.

Mr. WALLACE. Thank you, Mr. Matsui.

First, let me say I think there are a couple of aspects of that, and I am proud that and I am real proud of the realtors taking the stand. We have been for deficit reduction for about 5 years. We have had three for all programs, paying programs and a lot of others, and we are for it now, in any rational form. But, we have also, over the course of 1981, 1983, 1984, we gave at the office. I mean we have been players in reductions in HUD programs. And the 1983 act last year took a pretty big chunk out of our real estate hides. So we have been there, and we are going to be a player in both deficit reduction and I am sure tax reform you are not through with us. But, in this regard, I think what was created inadvertently by Congress last year and unknown by most of our industry, or we would not be here, was a gross overkill and inequity that ought to be corrected on its own merits. And I think you ought not to be looking for this as a vehicle for replacement revenues for a huge problem that we all agree needs to be solved. And so I say we have been a player, the National Association of Realtors is very much interested in deficit reduction. We certainly are players in tax reform. I suspect you are not going to let us off the hook and I am not encouraging you therein, but I do not think it is right when what you are dealing with is a gross inequity and one that has, whether you take the staff analysis that Treasury always used, and I understand you people have to deal with it that way, real world dynamic analysis, which I guess I should not spend much time on is, it is going to devastate—if their rules stuck, it is going to devastate the real estate economy. And so the revenues to State, Federal, and local governments are going to be down. And we have supporting data which we have submitted to indicate all of that.

Mr. Matsui. I am not unmindful of the fact that the equities are probably on your side because we did create the problem, and I would tend to agree with what you are saying now, but I think the reality is we may have to look for additional revenues to move any piece of legislation out of this committee this year and next year perhaps. I am not speaking about this piece of legislation. But I am not unmindful of the inequities that were created by us in 1984. Perhaps it was inadvertent. So, your statement is well taken.

I would like to call Mr. Daub at this time.

Mr. Daub. Thank you very much, Mr. Chairman.

Mr. Chairman, first let me congratulate you on your participation and effort to try to bring us to what I think in the end realistically will be middle ground. While I favor straight repeal, and argue with the assumptions of revenue loss, given the kind of market that we are going to be in, I think we have to give a lot of credit to folks that have been outside of this 10-mile square, which is oftentimes bounded by reality, trying to creatively keep a big part of our GNP and job base going while our fiscal policies inside the beltway have not been very conducive to their efforts. So I appreciate the efforts that you are making.

Can any of you, for the record, give us some concrete data with respect to whether or not the imputed interest provisions, since their enactment, have caused the delay or cancellation of projects or activities?

If we are dealing with assumptions, I would like to get that one out of the way. It sometimes bothers some of my colleagues, I think.

Mr. Sherman. Sir, I can only address one specific issue, and that was a property we had for sale in Houston, TX, last fall. As we began to move into the sale transaction, the imputed interest and the OID rules took effect. Attempting to understand the new law and its impact on the wraparound financing we tried to create, made it very difficult. And just at that time Treasury announced tax reform provisions, everything fell apart. It was impossible for the deal to go forward on that basis.

Mr. Daub. I know of an instance in my own State where a project just stopped and it has not been resurrected yet because of the uncertainty, but I was curious whether you could amplify your thoughts in that regard.

Mr. Wallace. Mr. Daub, I do not think you are going to get a lot of hard evidence because, for the most part, when seller financing is necessary is in a soft market, when it is down, and, for the most part, the period we have been in since last June 30 and/or the change, the interim transition rules in October, there have been plenty of institutional funds available. So, again back to our earlier analysis, the seller financing is the financing of last resort, so, for the most part, I do not think you could track a very good record. Therefore, that is why I took you back to 1982.

Mr. DAUB. I understand. I was not here for your basic testimony. I read each of your statements, and I have a lot of farmers who can testify to the fact that their lawyers have advised them not to make transactions with their children at this point until we know what this issues resolution will be.

Mr. Driesler or Mr. Smith, did you have anything to add?

Mr. SMITH. I think it is hard to tell at the moment. I do not think there is any question that it has created disruption in the real estate industry, and people are not moving forward on some of their projects. The whole tax situation that is up in the air right now is creating enormous disruption out there and ultimately I think we are going to be paying a price for that if we cannot get it resolved. So, it is hard to give you concrete evidence, but, certainly, we know it is happening and we are hearing of cases across the country where it is happening.

Mr. DRIESLER. We can all point to examples within our membership of deals that have fallen through, or had to be restructured because of these rules. But, in terms of any gross numbers because of the change in interest rates and other factors, we do not have any, and I think it would be difficult.

Mr. DAUB. A lot of times Congress does not act when interest rates are down and the pressure of uncertainty does not seem to be so imminent as requiring you to keep a log book under your pillow at night. So, I was just curious about that.

Let me ask one last point, Mr. Chairman, if I might.

This is complicated, and I raised the issue before, wraparound, with the Secretary when he was here. Some of you heard that. Number of proposals advocated by various industry groups suggest that assumptions and wraparound mortgages not be treated as new debt for imputed interest purposes. In fact, the temporary legislation of last October did permanently eliminate most assumptions. Pre-October 16, 1984, debt from the imputed interest rules.

As I understand the industry's position, it does not want wraparound mortgages treated as assumptions; it does not want to do this, for purposes of installment sale provisions. The position is, of course, understandable because if the wraparound were treated as an assumption, it would result in immediate taxation of the gain, where if it is not treated as an assumption, the taxation of gain is delayed.

Can you explain to me the rationale for treating assumptions and wraparounds in a similar manner for purposes of imputed interest, but not treating wraparounds and assumptions for purposes of installment sales?

Mr. DRIESLER. We do not think wraps should be treated the same as assumption for imputed interest. If you are going to be fair, you have got to treat them consistently. And we think the installment sale treatment is the proper treatment. Therefore, wraparounds under imputed interest ought to be treated not as an assumption, but as new financing.

Mr. SHERMAN. Sir, I believe wraparound financing, the installment sale effects of having wraparound financing, simply allows a seller to match the tax consequences with the cash that is received.

And, therefore, when he receives a relatively small amount of cash up front, he would otherwise be made to pay a significant amount of tax consequences. And by using the installment sale method, it simply preserves the ability to match tax and cash. I think that is very important in business.

Mr. DAUB. My comment, Mr. Chairman, with no more questions, is, of course, what we may do on RCRS or ACRS in capital gains, as asserted before, is going to have a massive consequence relative to what we do on this issue now or later.

Thank you very much. We appreciate your testimony, gentlemen.

Mr. MATSUI. Thank you, Mr. Daub.

I would like to thank all four of you for your excellent testimony. I appreciate it very much and we will be in touch with you.

Thank you.

I would like at this time to call on the third panel: Mr. McDonald Williams, from the National Realty Committee; Mr. Wallace Woodbury from International Council of Shopping Centers; and Mr. Ronald L. Simpson, the Building Owners & Managers Association international president.

Mr. Williams, you may proceed.

STATEMENT OF J. McDONALD WILLIAMS, CHAIRMAN OF THE BOARD, NATIONAL REALTY COMMITTEE

Mr. WILLIAMS. Thank you, Mr. Chairman.

My name is Don Williams. I am the managing partner of the Trammell Crow Co. I am chairman of the National Realty Committee.

With your permission, I would like to request the written statement be put in the record and I will make a few off-the-cuff comments, if I may.

Mr. MATSUI. Without objection.

Mr. WILLIAMS. Basically, as has been reiterated all morning, the OID rules, of course, are aimed at certain tax abusive transactions. And certainly there are some, but I think it would be fair to say that the 1984 Tax Act has eliminated a lot of the tax abuses that found their way into purchases and sales as well as other forms of real estate transactions. Specifically, as an example, I am referring to the current nondeductibility of accrued interest. But, in the main, those of us that are in the business nationwide, I think, would subscribe to the view that most real estate purchase and sales are simply not tax motivated—that is simply not the driving force behind them.

Admittedly, under the 1981 Tax Act which with ACRS permitted 15-year depreciation, we have had in the last 3 or 4 years probably more tax-motivated transactions in real estate than maybe in the history of our industry up until now. But, again, I think we would say that the 1984 act largely eliminated the deep shelter abuses that were characteristic of those transactions. So, in some ways, I feel like we are sort of fighting a battle that does not exist anymore with what Congress did in the 1984 Tax Act.

Again, to reiterate, setting the interest rates in most purchases and sales on an installment basis is not motivated by tax aspects. Interest rates are typically negotiated and, in many cases, are below market interest rates. But there are many times very valid economic reasons for that. For example, at the moment we are seeing distressed transactions where the buyer simply will not buy, except for a reduced price and a reduced interest rate, because the property is not leased, or will not sell, and there is no other alternative when it is in a workout mode. And that may include financial institutions who want to remove property from their balance sheet, or others who want to sell because they can no longer afford to carry it. A very legitimate reason then exists for a very low or deferred interest rate.

A second case exists when you have tight money market conditions. In the last few years we have had a substantial flow—in fact, an excessive flow—of capital into our industry. That is now changing. There is a slowing flow of capital into the real estate industry. The other side of that, of course, frequently is high interest rates. In 1981-82, for example, when we had 19, 20 and 21 percent interest rates, real estate deals simply did not yield enough to pay that kind of interest. Therefore, during such time of high interest rates if you are to have liquidity in real estate transactions, for example, where you can sell a building or land, you are going to have to have lower interest rates so there can subsequently be an earn out for the buyer; or you simply kill in its tracks any kind of liquidity associated with our industry.

So there are a number of reasons for lower interest rates other than tax motivations. In fact, from our experience nationwide, I would say that that is the general rule not the exception.

The upshot of all of this, if we get high interest rates on installment sales, we are going to see a dramatic slowing of the number of transactions.

I was interested that Mr. Pearlman this morning in his testimony said he accepted it as given that there would be a stifling effect on real estate transaction flow with the high OID rates; but then he said the cure to that is to exempt out the small transactions.

Well, we are in favor of that, if it comes down to that point, but, really, are higher interest rates of benefit to our economy as a whole? Is it really in our economy's interest if small deals are excepted only and large deals then are prohibited or stifled, per his testimony?

So I would say that on balance, if there are to be OID rules, and we are not going to have repeal, we would favor the approach taken in Representative Matsui's bill with just a couple of minor points. May I be permitted to deal with those?

First, we would suggest an 80-percent AFR rate and a current determination of the interest rate; that is, no long time lags before the interest rate is set into effect.

Second, we would recommend and propose that all assumption debt or subject to debt be exempt from OID. Let us not retroactively change deals negotiated years ago.

Third, a lot of real estate today is financed by participating debt. That is, the lender will take a below market threshhold rate and a percent of the cash flow or a percent of the profits or a partial accrual rate for future income. And those are arms length negotiated deals because, again, the project today will not yield enough to pay current interest rates, so the lender or investor will take a deferral in order to get a higher return in the long run.

We would propose that those transactions be exempted as well, that is, let the business deal stand as negotiated.

As to variable rates, as long as the rate is at arms length at the time negotiated and pegged to some industry standard, again there is no tax-abusive intention. Why not let that agreement stand for the life of the transaction instead of having to alter it from time to time?

On the aspect of mismatch, addressed in Representative Matsui's bill, we would surely concur with the cash-cash option—many small developers and owners in our business are not set up from an accounting standpoint to do accrual basis accounting. So you are talking about a lot of cost as well as complexity in general.

Thank you.

[The prepared statement follows:]

STATEMENT OF J. MCDONALD WILLIAMS, CHAIRMAN OF THE BOARD, NATIONAL REALTY COMMITTEE

Mr. Chairman. My name is J. McDonald Williams. I am the Managing Partner of the Trammell Crow Co. in Dallas, Texas. I appear before the Committee today in my capacity as Chairman of the Board of the National Realty Committee ("NRC"). My statement presents the views of the NRC on the application of the original issue discount ("OID") rules to obligations issued for property and services. NRC is a nonprofit business league representing a significant and diverse cross-section of the real estate industry. NRC members include owners, operators and developers of all types of real estate throughout the United States. As a broad-based organization, NRC is concerned with the overall health and growth of the real estate industry.

NRC recognizes the reasons underlying the revision and expansion of the OID rules in the Tax Reform Act of 1984. During Congressional consideration of that legislation, NRC supported OID changes in principle. At that time, however, NRC expressed concern about the complexity and uncertainty of the OID rules. Last fall in H.R. 5361, the Congress enacted transitional and grandfather rules delaying the full impact of the 1984 Act amendments but not addressing the substantial difficulties posed by the imputed interest rules. NRC believes that simplification and clarification of these rules is needed prior to the OID provisions' impending July 1, 1985 effective date. Legislation improving the OID provisions should be enacted promptly.

The OID rules should be amended in 3 general ways:

1. The OID interest rate structure should be simplified and the rates reduced.
2. Application of the OID rules should be clarified, particularly with respect to variable interest rates, contingent interest and assumed obligations.
3. The OID rules and other accounting provisions should be modified to recognize business practice and necessity where tax avoidance potential is insignificant or nil.

INTEREST RATE STRUCTURE

a. Simplification

The new OID imputed interest rules apply to a test rate of 110 percent and an imputation rate of 120 percent, where required, of the applicable Federal rate ("AFR"). There are three AFRs, one each for short-term, mid-term and long-term obligations. The statute bases the AFRs on the average of such rates for the six-month period ending on the immediately preceding September 30 or March 31. Because the AFR determined under the statutory rule may be based on rates in effect from 3 to 15 months before a transaction, the AFR may vary significantly from current market rates. The decline in interest rates from late 1984 into early 1985 has resulted in market rates in 1985 which are lower than the AFR determined under the statutory six-month method. To alleviate this problem, the Internal Revenue Service announced on February 13, 1985, that it would provide an alternative method of computing AFRs for the one-month period ending on the 14th day of the preceding month and announcing the alternative AFRs on approximately the 20th day of that month. The alternate rate will be available for the two succeeding months. However, the alternate rate will be used only in lieu of a higher (but not a lower) rate computed on the statutory six-month basis.

NRC recognizes that provision of alternate monthly rates will reduce, although not wholly eliminate, the time-lag problem. The cost of more current AFRs under the present statute is increased complexity. As a result of this alternate system, several rates may apply within a given month. Taxpayers will have to select the AFR from two or more rates and use the 110 percent and 120 percent testing and imputation rates.

For example, a seller financing 10 million dollars of the purchase price of property in April 1985 for 6 years will compare four different rates to determine the AFR. The AFR will be the lowest of the six month mid-term rate published for January 1–June 30, 1985 (13.37%), the mid-term rate for April (11.84%), the mid-term rate for March (11.30%) or the mid-term rate for February (11.48%). (See attached revenue rulings.) The March mid-term of 11.30% is the lowest and therefore the AFR. The test rate will be 110% or 11.30%, or 12.47%. The purchase money mortgage will bear adequate interest and avoid application of the OID imputed interest provisions if it bears stated annual interest of at least 12.47%.

NRC urges that the OID rules be simplified by repealing the statutory six-month base average and substituting monthly (or more frequent) determinations. In addition, to reduce computations further, a single test and imputation rate should be used.

The OID provisions in the 1984 Act and the interim legislation create relaxed or simplified tests or total exemptions from certain rules for loans for amounts below specified levels. NRC sees no principled reason for imposing different treatment on loans of different amounts. Nevertheless, as a practical matter, NRC has no objection to providing simplified rules for smaller loans, for example, those for below $2 or $4 million. However, even if small loans receive special treatment, NRC believes it imperative to simplify the OID rules for all loans, regardless of size, and particularly those not involving tax abuse potential as hereinafter described.

b. Rate reduction

NRC recommends that a rate below 100 percent, say 80 percent, of the AFR would serve to protect the fisc while allowing taxpayers to complete transactions which they consider desirable for business and economic reasons, even if concluded at a rate somewhat below the AFR.

The impact of the OID provision on transactions becomes more severe as interest rates rise. Typically, interest rates increase directly in relation to inflation. Therefore, in periods when inflation causes high nominal interest rates, the OID rules applying money market rates to deferred payment sales will have several objectionable results.

Applying high, inflation-driven interest rates to property transfers will serve to stimulate inflation further. Instead of only reflecting inflation, interest rates required by tax considerations will contribute directly to increase it.

The uniform application of high interest rates disregards the genuine business motivation behind transactions involving comparatively lower rates set for sound economic reasons and not for tax avoidance. Buyers simply will not pay interest currently at very high rates for property which is acquired for its inflationary appreciation potential but which lacks any significant current cash flow.

CLARIFICATION

The imputed interest rules, and their legislative history, provide little or no clear guidance concerning the treatment of several common business features of debt transactions: variable interest rates, contingent interest and assumed obligations. It would be remiss if reconsideration of the OID rules fails to address these common arrangements.

a. Variable rates

Lending institutions, as well as many private lenders, frequently charge interest for their funds by reference to the prime rate of a major financial institution. Some lenders and borrowers seek to base their interest charges and costs by reference to objective public indexes or widely-traded debt instruments in order to facilitate hedging their respective positions.

NRC uges that variable rates be considered acceptable for purposes of meeting the OID testing requirements provided the variable rate stated in the contract—(1) is pegged to an objective and publicly available rate or index which varies directly with changes in market interest rates, and (2) the initial rate established as of the contract date equals or exceeds the OID testing rate. For example, a variable rate determined by reference to the published prime rate of a large financial institution would be an appropriate interest measure.

b. Contingent interest

Transactions may provide for interest which is stated and therefore measurable, but which is payable only if some contingency occurs. Typical contingencies are certain standards or levels of cash flow, receipt or similar items. In addition, a rate of interest might be stated but payment of part or all of such interest deferred until a specified contingency occurs. Because of restrictions on rent and on distributions, subsidized housing often lacks cash flow adequate to make full interest payments and frequently involves contingent, deferred interest.

NRC believes that applying the OID rules in their present form in the case of contingent, deferred interest payments is not feasible. NRC recommends that where deferral serves a business (and not a tax avoidance) purpose, both the payor and payee of such interest account for it for tax purposes under the cash receipts and disbursements methods of accounting. For this cash accounting rule to apply, the contingency which would result in deferral must be genuine. In addition, a safe harbor could be created for contingent interest which is dependent on legitimate contingencies. Under such a rule, stated and contingent interest would together be treated as adequate interest provided (1) the stated interest rate is equal to a minimum percentage of the AFR, and (2) the combined value of the stated and contingent interest would be equal to 110% of the AFR.

NRC also believes that deferral of the payment of some portion of interest should be permitted in limited circumstances without subjecting an obligation to the imputed interest rules, provided the obligation's stated rate is adequate. NRC recommends that deferral of the payment of some interest should be permitted, without requiring application of the interest imputation rules to an obligation for up to two years after issuance of the obligation, provided the obligation requires current payment of a substantial portion of its stated interest. Requiring cash accounting by payor and payee might be appropriate in this situation as well.

It should be noted that a reduction in the OID rule test rate would alleviate the problems posed by contingent interest in the case of many transactions requiring both a stated, fixed rate of interest and a supplementary contingent percentage. The lower the test rate is, the greater would be the likelihood that the stated, fixed rate would be adequate to satisfy the test rate, making it unnecessary to apply the OID provisions to the additional contingent interest.

c. Assumed obligations

NRC believes that if a debt obligation is assumed in connection with the sale or exchange of property, or if property is taken subject to a debt obligation, such assumed obligations should not be subject to the imputed interest rules provided the obligation is not modified in connection with the transaction. Neither the original bills nor the Committee reports on the 1984 Act applied the OID provisions to assumed obligations. The Conference Report, however, authorized regulations, similar to existing regulations under Code section 483, to apply to the OID rules to assumed deferred payment obligations and assumed obligations to third-party lenders. Subsequent legislation added section 44(b)(5) to the 1984 Act to apply the OID to such obligations.

Applying the OID rules to assumed obligations will substantially alter many typical real estate transactions. Significant amounts of principal payments will be converted to interest. Depreciable basis will be reduced. Cost recovery deductions will be treated as interest expenses, subject to the Code's limitations on interest deductions. Amounts previously considered capital gain will become ordinary income.

Assumptions unaccompanied by any material change in the obligation are distinguishable from the creation of new obligations. A seller and purchaser entering into a new purchase money obligation are free to negotiate a principal amount and interest rate with or without reference to the then applicable Federal rates but, in transactions involving the purchase of property subject to existing obligations, the opportunity for conscious manipulation of relative principal and interest amounts is limited. The only alternative to closing the transaction subject to the existing obligation is to pay off such obligation in full, and even that option may be limited by any restrictions in the debt instrument against a free right to prepay. In addition, application of the OID rules to assumptions of preexisting indebtedness reflects an attempt to fragment the value, and therefore the approriate purchase price, of a parcel of real property separate and apart from the value inherent in any indebtedness then a lien against such property. Such fragmentation is contrary to all past practice, is inconsistent with the lack of any comparable fragmentation of other factors implicit in the overall value of commercial real property (such as the existence of long-term leases which may either enhance or depress the value of the property on an unencumbered basis), and is not needed to prevent any abuse. Where the debt instrument originally taken back by the seller bore an actual or imputed rate of interest then appropriate under either Section 483 or Section 1274 of the Code at the time entered into (and in all cases where the instrument was created in exchange for money actually lent), there is no persuasive reason for imputing a readjustment in the interest rate merely by reason of a subsequent transfer or property subject to such obligation.

In addition, prescribing OID regulations for assumed obligations which follow all aspects of the present section 483 regulations would be unreasonable. The present section 483 regulations appear to assume static interest rates. They conflict with some purposes of the 1984 Act rules and make inappropriate distinctions. Under the present section 483 regulations, an obligation is treated differently upon its assumption depending upon whether or not it originally had adequate stated interest which would be subject to retesting upon assumption, while obligations which originally had interest imputed would not be subject to retesting.

NRC believes that 1984 Act section 44(b)(5), as well as the earlier Conference Report authorization to apply the OID rules to assumed obligations, is ill-advised and should be repealed. Nevertheless, in the event that any imputed interest rules are to be applied to assumed obligations, only the purchaser should be affected by such rules. Sellers should not be affected because they were subject previously to testing and interest imputation, if applicable, with respect to the obligation when they orginally entered into it. Their legitimate expectations thereafter should not be upset.

In no event should the imputed rate for assumed obligations exceed the AFR. The rate imputed on an assumed obligation, at most, should bring the obligation up to the current market rate. Applying a "penalty rate" to assumed obligations is inappropriate. A buyer ordinarily had no control over the assumed obligation's original stated rate. Therefore, a buyer should not be subject to an imputed penalty rate merely because the original rate, set perhaps years earlier, falls below testing (or market) levels at the time of the assumption. Any new OID regulations should not adopt the unreasonable distinctions made by the present regulations under Code section 483.

While unnecessary complexity can be avoided by expecting real estate transactions involving assumed obligations for small amounts in excess of a de minimus figure should be governed by the same rules. In this regard, obligations assumed in connection with real estate transactions should not be treated less favorably than obligations assumed in connecton with other types of transactions.

TAX ACCOUNTING MODIFICATIONS

The 1984 Act imposed new accounting rules on a range of transactions, including transactions between partners and partnerships, and between other related parties. Generally, these rules imposed consistent accrual accounting, frequently on an economic or OID basis, on payors and payees. NRC appreciates that under prior law some taxpayers had exploited the timing differences between the cash and accrual methods of accounting in structuring transactions between cash and accrual basis taxpayers which were abusive of the tax system and detrimental to the fisc. Clearly, NRC agrees, some anti-abuse measures were needed.

The new anti-abuse accounting rules, however, have greatly increased the complexity of tax accounting for many taxpayers. Some affected taxpayers now may find themselves accounting generally on the cash method but reporting separate transactions on the accrual method. Other accrual basis taxpayers may be reporting some transactions under the cash method upon payment or receipt.

For some taxpayers, accrual accounting will create significant economic hardships. Under the accrual method some taxpayers will be required to report and pay tax on income which they will not in fact receive for years hence.

The across-the-board application of the new rules and the strong preference which they evince for the accrual method seem inappropriate and unnecessary. Many taxpayers with no tax-avoidance intent and many transactions totally lacking in tax-avoidance potential fall within their ambit. Taxpayers must learn and follow two (or more) different systems of accounting at the same time. The simplicity of the cash method has been supplemented, or in some cases replaced, by more difficult accrual principles.

Contrary to the policy apparently underlying the 1984 Act rules, accrual accounting is not superior to the cash method in all circumstances. As a theoretical matter, accrual accounting may provide a more accurate reflection of income. As a practical matter, however, accrual accounting would require many ordinary taxpayers long used to the easier cash method to master new and difficult principles and to keep more complicated records. Such a transition would be unduly burdensome for many taxpayers and in many cases unrewarding for the Treasury as well. The familiarity and ease of the cash method for many taxpayers should not be undervalued.

NRC believes that more exceptions from accrual accounting can be permitted without creating a danger of abusive tax shelters. NRC endorses the suggestion made by some legislators, that if both parties to a transaction agree to report payments and receipts on a cash basis, the accrual method need not be mandatory. NRC would not limit this cash basis election to small denomination loans, but would extend it to all loans. To insure that transferees of the original parties adhere to this bilateral election, it might be required that the election be expressly incorporated in the loan agreements.

If a bilateral election of cash method of accounting is allowed for only small transactions (or for none), NRC believes that other exceptions to mandatory accrual can be safely provided. The OID accrual rules were intended to prevent tax sheltering resulting from the overstatement of basis and concomitant increased depreciation deductions. Therefore, transactions which do not afford opportunities for such abuses should be excepted from mandatory accrual accounting. For example, purchase money loans for land and other nondepreciable property could be expected without endangering tax revenues. In addition, many loans for depreciable property afford little tax abuse potential. Examples of loans with little abuse potential would be loans for amounts constituting only a modest percentage of the basis of depreciable property and loans with respect to depreciable property possessing a recovery period longer than the term of the loan.

[Attachment 1]

PART I

Section 1274—Determination of Issue Price in the Case of Certain Debt Instruments Issued for Property. (Also Sections 467, 483, 7872; 1.483—1.)

Rev. Rul. 85—51: For purposes of section 1274(d) of the Internal Revenue Code, the short-term, mid-term, and long-term applicable federal rates (AFR) for the six-month period, July 1, 1985 through December 31, 1985, are as follows:

[In percent]

	Period for compounding			
	Annual	Semiannual	Quarterly	Monthly
Short term:				
Applicable Federal rates	10.41	10.15	10.02	9.94
Applicable Federal rates (110 percent)	11.48	11.17	11.02	10.92
Applicable Federal rates (120 percent)	12.55	12.18	12.00	11.88
Mid term:				
Applicable Federal rates	11.78	11.45	11.29	11.19
Applicable Federal rates (110 percent)	13.00	12.60	12.41	12.28
Applicable Federal rates (120 percent)	14.21	13.74	13.51	13.36
Long term:				
Applicable Federal rates	12.07	11.73	11.56	11.45
Applicable Federal rates (110 percent)	13.32	12.90	12.70	12.57
Applicable Federal rates (120 percent)	14.58	14.08	13.84	13.68

The tables below are designed to assist readers in determining this month's safe harbor interest rates that must be incorporated in debt instruments and similar transactions under sections 280G (relating to "golden parachute" arrangements), 467 (relating to deferred payments for the use of property), 468 (relating to mining and solid waste reclamation and closing costs), 483 (relating to interest on certain deferred payments), 1274 (relating to the determination of issue price in the case of certain debt instruments issued for property), and 7872 (relating to certain low-interest and interest-free loan transactions). Generally, an instrument must carry an interest rate of at least 110 percent of the "applicable federal rate," (AFR) or the IRS will impute an interest rate equal to 120 percent of the AFT. (See *Tax Notes*, November 12, 1984, p. 605.)

Safe harbor rates. Table 1 sets forth the AFR for the period January 1, 1985 through June 30, 1985 determined under section 1274(d). Table 2 sets forth the AFR for the month of April computed under the alternate method specified in section 1.1274-6T of the temporary regulations. Table 2 is effective for purposes of applying code sections 467, 483, 1274 and 7872 whenever the rates calculated under the alternate method are *lower* than the six-month rate determined under section 1274(d).

TABLE 1—JANUARY 1, 1985–JUNE 30, 1985 AFR

[In percent]

	Annual	Semiannual	Quarterly	Monthly
Short term: [1]				
Applicable Federal rates	12.37	12.01	11.83	11.72
Applicable Federal rates (110 percent)	13.65	13.21	13.00	12.86
Mid term: [2]				
Applicable Federal rates	13.37	12.95	12.75	12.61
Applicable Federal rates (110 percent)	14.75	14.25	14.00	13.84
Long term: [3]				
Applicable Federal rates	13.43	13.01	12.81	12.67
Applicable Federal rates (110 percent)	14.82	14.31	14.06	13.90

[1] Not more than 3 years.

[2] More than 3 years but not more than 9 years.

[3] More than 9 years.

Source: Rev. Rul. 84-163. Tax Notes, Nov. 12, 1984, p. 605.

TABLE 2—APRIL 1985 AFR

[In percent]

	Annual	Semiannual	Quarterly	Monthly
Short term:				
Applicable Federal rates	10.37	10.11	9.99	9.90
Applicable Federal rates (110 percent)	11.43	11.12	10.97	10.87
Applicable Federal rates (120 percent)	12.50	12.13	11.95	11.83
Mid term:				
Applicable Federal rates	11.84	11.51	11.35	11.24
Applicable Federal rates (110 percent)	13.06	12.66	12.47	12.34
Applicable Federal rates (120 percent)	14.29	13.81	13.58	13.43
Long term:				
Applicable Federal rates	12.22	11.87	11.70	11.59
Applicable Federal rates (110 percent)	13.49	13.06	12.85	12.72
Applicable Federal rates (120 percent)	14.75	14.24	14.00	13.84

Source: Rev. Rul. 85-40, Tax Notes, April 15, 1985, p. 264.

Special safe harbor. The temporary regulations provide a special safe harbor for section 483 and section 1274 transactions. (See Treas. Reg. sections 1.483-2T and 1.1274-3T). Solely for determining if a contract has unstated interest under section 483 or for determining if a debt instrument issued in exchange for property has adequate stated interest under section 1274, the AFR will be the lowest of:

The six-month AFR (Table 1); the monthly AFR for the month for which the determination is being made (Table 2); the monthly AFR for the month preceding the month for which the determination is being made (Table 3); the monthly AFR for the second month preceding the month for which the determination is being made (Table 4).

If it is determined that a contract has unstated interest under section 483 or that a debt instrument has inadequate stated interest under section 1274, the rates for the prior two months (Table 3 and 4) do not apply in determining the amount the IRS will impute.

These tables will be updated as new rates are determined.

TABLE 3—MARCH 1985 AFR (SPECIAL SAFE HARBOR)

[In percent]

	Annual	Semiannual	Quarterly	Monthly
Short term:				
Applicable Federal rates	9.77	9.54	9.43	9.36
Applicable Federal rates (110 percent)	10.77	10.49	10.36	10.27
Applicable Federal rates (120 percent)	11.78	11.45	11.29	11.19
Mid term:				
Applicable Federal rates	11.30	11.00	10.85	10.76
Applicable Federal rates (110 percent)	12.47	12.10	11.92	11.81
Applicable Federal rates (120 percent)	13.64	13.20	12.99	12.85
Long term:				
Applicable Federal rates	11.72	11.40	11.24	11.14
Applicable Federal rates (110 percent)	12.93	12.54	12.35	12.22
Applicable Federal rates (120 percent)	14.15	13.68	13.45	13.31

Source: Rev. Rul. 85-25, Tax Notes, March 18, 1985, p. 1099.

TABLE 4—FEBRUARY 1985 AFR (SPECIAL SAFE HARBOR)

[In percent]

	Annual	Semiannual	Quarterly	Monthly
Short term:				
Applicable Federal rates	9.79	9.56	9.45	9.37
Applicable Federal rates (110 percent)	10.80	10.52	10.39	10.30
Applicable Federal rates (120 percent)	11.80	11.47	11.31	11.21
Mid term:				
Applicable Federal rates	11.48	11.17	11.02	10.92
Applicable Federal rates (110 percent)	12.67	12.29	12.11	11.99
Applicable Federal rates (120 percent)	13.85	13.40	13.18	13.04
Long term:				
Applicable Federal rates	11.92	11.58	11.42	11.31
Applicable Federal rates (110 percent)	13.15	12.74	12.54	12.41
Applicable Federal rates (120 percent)	14.38	13.90	13.67	13.51

Source: Rev. Rul. 85-21. Tax Notes, March 11, 1985, p. 983.

Mr. MATSUI. I would like to call on Mr. Woodbury.

Mr. Woodbury.

STATEMENT OF WALLACE R. WOODBURY, CHAIRMAN, TAX SUBCOMMITTEE, GOVERNMENT AFFAIRS COMMITTEE, INTERNATIONAL COUNCIL OF SHOPPING CENTERS

Mr. WOODBURY. Thank you, Mr. Chairman.

My name is Wallace R. Woodbury. I am an attorney and chairman of the board of Woodbury Corp. in Salt Lake City, UT. We are real estate brokers, managers, developers and consultants.

I am also chairman of the Tax Subcommittee of the Government Affairs Committee of the International Council of Shopping Centers. I am presenting this testimony on behalf of the members of that council.

The ICSC believes that seller financing is an essential factor in facilitating the sale of shopping centers as well as other real estate transactions.

The new rules in the 1984 act substantially eliminate such financing for shopping center transactions, primarily because the maximum interest rates required are artificially high and substantially higher than traditional norms for seller financed transactions.

We believe that the best solution is outright repeal in the interest of simplification and eliminating deterrents to economic, nontax-motivated seller financed transactions. However, if the Congress feels that any portion of the provision should be retained in the law, it is important that the law be substantially amended. Perhaps the most logical goal that might be worth preserving is the attempt to avoid a mismatch of income and deductions between buyer and seller.

This might require more uniformity of their accounting methods and additional changes to more equitably avoid a mismatch.

Beyond that point, the ICSC believes that the new rules have an unintended adverse economic effect because the underlying economic theory upon which the new rules were based is clearly incorrect, and because the test rate of 110 percent of AFR bears no consistent relationship to the real market interest rate for seller financed real estate loans.

Additionally, the Treasury assumptions that sellers and buyers usually manipulate sale price and interest rate for tax-motivated reasons is totally contrary to our market experience. I have been a broker since 1946, and I have rarely, if ever, had that occurrence. There are rare exceptions.

Additionally, the new rules fail to provide reasonably either for related third party financing such as assumptions and wraparounds, or for two other areas that really have not been discussed by any of the witnesses. The first is for the imputed capital loss on investment—to section 1221—properties such as vacant land and certain farmlands which may already be in a loss position, and also personal use properties. Second, it also aggravates a mismatch instead of avoiding it in the case of income and deductions of a seller and buyer of investment properties, where the buyer may be subject to investment interest deduction limitations and, yet, you are imposing upon the seller the requirement to pay the additional interest.

The assumed simple inverse relationship between interest rates and value simply does not exist. Over the range of interest rates of most importance under the new rules when rates are high by historic standards, there is no relationship whatsoever.

Real property value does not respond like a Government bond. A bond has fixed coupon rates, fixed value at maturity. Real property has uncertain rentals, uncertain operating costs and factors on maturity which involve all kinds of inflationary factors, et cetera.

We believe the test rate should be adjusted, if we do have such a thing, to provide more stability and to minimize the occurrence of test rates which do stop legitimate seller financed transactions.

We believe it might be right to impose a ceiling on how far the test rate can fluctuate.

We believe there should be less stringent tests, and perhaps exemptions should be applied to certain types of property and transactions where they are unlikely to involve a tax abuse. Transactions, for instance, with obligations that have relatively short maturities; relatively high percentages of interest paid up front and transactions involving nondepreciable property. In fact, in the case of nondepreciable property, such as investment property, the imputing of interest actually would reduce Federal revenue if there were a matching of interest deductions and expenses. Because interest revenues would be neutral and you would reduce the capital gain by imputing a lower sale price, and there are no depreciation ACRS or investment tax credit factors involved. Therefore, it would actually reduce the revenue to the Federal Government in a case of those properties.

So, perhaps the real solution for personal residences, and other nondepreciable properties, such as investment property, is to create an exclusion for those types of assets from the law completely.

We have many other things which we want included in the record.

Mr. Chairman, we think that one other issue that really has not been raised adequately is that it is unfair to have an imputation rate that is higher than the test rate. If the test rate is a rate that is presumably what people ought to be charging, why penalize these unwary people who do not know about this complex law by thrusting upon them an imputed rate that is a penalty.

Then, on revenue loss estimates since you have asked the question, I think that it is clear that the macroeconomic effect of slowing down these transactions is such that it would reduce Federal revenues. As I pointed out, applying the rules to investment properties and residences may decrease Federal revenues rather than increase them by applying the rule. So I think they really require a reexamination.

Thank you, Mr. Chairman.

[The prepared statement follows:]

Statement of Wallace R. Woodbury, Chairman, Tax Subcommittee, Government Affairs Committee, International Council of Shopping Centers

SUMMARY

The International Council of Shopping Centers (ICSC) supports the accounting provisions of the new original issue discount and imputed interest rules, which are designed to prevent the mismatching of interest income and deductions, and the use of a compounded test rate to determine the adequacy of interest payments. However, the economic theory which purports to support the new rules is fundamentally flawed and the excessively high test rates and other provisions of the new rules would effectively prohibit many legitimate, economic, seller-financed transactions involving shopping centers.

The economic theory underlying the new rules is flawed because it is based on the presumption that there is a fixed relationship between the yields on federal obligations at the time of sale and the fair market value of real property sold in a seller-financed transaction. This presumption is incorrect. It is refuted by sound economic theory and by the actual practices of buyers and sellers of real property. In addition, the test rate applicable to most shopping centers under the new rules, 110 percent of the current yield on federal obligations of similar maturities, is excessively high and bears no relationship to the interest rates traditionally used in the financing of real property.

For these reasons, ICSC believes that the best solution to the problems created by the provisions of the new rules requiring minimum interest rates in seller-financed real property transactions is to repeal these provisions of the rules while retaining the anti-mismatch accounting rules. However, if the committee believes that the test rate provisions of the new rules must be salvaged, ICSC believes that the OID and imputed interest rules should be amended as follows:

1. The test rate should be revised to provide more stability and to minimize the occurrence of test rates high enough to stop seller financing. In addition, the test rate should have a ceiling designed to prevent short-run increases in the test rate

from stopping seller financing, particularly in times of abnormally high interest rates. This ceiling rate should be related to the long-run range of capitalization rates used to define the value of real property in relation to current operating income.

a. One alternative is to base the test rate on the Federal Home Loan Bank Board's Cost of Funds Index (COF Index). The test rate should be no higher than 100 percent of the COF Index.

b. If the test rate must be based on the applicable federal rate (AFR), two approaches should be considered. First, the test rate could be set equal to the sum of 9 percent plus a fraction of the difference between the AFR and 9 percent. This would moderate the volatility and peak values of the AFR. Second, the test rate could be set equal to no more than 80 percent of the AFR.

c. Another approach is to set a test rate equal to 10 percent, compounded, which is a substantial increase over the 9 percent simple interest requirement of the OID imputed interest rules for medium-term and long-term debt.

d. Another approach is to make the former section 483 imputed interest requirements applicable to real property. This would permit the Treasury to set the test rate by regulation to reflect changes necessary due to changing market conditions.

2. Less stringent test rates or exemptions from the test rate provisions should be applied not only to certain types of property and certain monetary levels of transactions, but also to transactions that are extremely unlikely to involve tax abuse, i.e., transactions with obligations that have relatively short maturities and relatively high percentages of interest paid currently, or transactions involving nondepreciable property.

3. The test rate should not be biased against variable and contingent interest rate loans by considering only the base interest rate when applying the test. The test must consider all of the interest payments in such transactions.

4. Assumed debt and the existing debt portion of wraparound obligations should not be subject to the test because such debt was tested when originally issued and cannot be manipulated to suit the tax situations of the buyer and seller.

5. When both buyer and seller have already established the same accounting method, they should be required to use this method for seller-financed transactions regardless of the size of the debt. If their established accounting methods differ, then cash accounting should be required for the buyer and seller in smaller transactions and accrual accounting should be required for both buyer and seller in larger transactions.

6. The imputation rate should be the same as the test rate because the rules are likely to be complex enough to constitute a trap for the unwary, because it is questionable whether exceeding any test rate indicates anything about either tax motivation or tax impact, and because this will bias financing away from sellers and toward institutional lenders.

7. Interest should not be imputed where it would create or increase a non-deductible capital loss on "investment assets", including vacant land and some farm land, and on personal residences.

8. Imputed interest should in all cases be currently deductible by the buyer. Mismatch between the buyer's interest deductions and the seller's interest income should not be created or aggravated by the combined application of the investment interest deduction limitations (which prevent the buyer from deducting actual and imputed interest payments) and the imputation of interest under the new rules.

STATEMENT

I. Introduction

My name is Wallace R. Woodbury. I am an attorney and the Chairman of the Board of The Woodbury Corporation of Salt Lake City, Utah. We are real estate brokers, managers, developers, and consultants. I also am Chairman of the Tax Subcommittee of the Government Affairs Committee of the International Council of Shopping Centers (ICSC), and I am presenting this testimony on behalf of the members of ICSC.

ICSC is the trade association of the shopping center industry. ICSC has approximately 12,000 members, consisting of shopping center developers, owners, operators, tenant retailers, lenders, and related enterprises. The ICSC represents a majority of the 25,000 shopping centers in the United States.

A. The shopping center industry

It is estimated that in 1984 shopping centers accounted for 45 percent of total U.S retail sales, and that this figure will increase to between 50 percent and 55 percent by 1990. In current dollar value, U.S shopping center retail sales reached a level of $475 billion in 1984.

It also is estimated that between 5.7 and 6.5 million people are regularly employed in shopping centers and that several hundred thousand more are annually engaged in new construction, expansion, and renovation of shopping centers. The effect of shopping center development on employment in related businesses, including the manufacture of goods sold in the centers, advertising, maintenance and cleaning, and accounting is considerable.

B. Involvement of the shopping center industry in the resolution of the imputed interest issue

Seller financing has been a very important factor facilitating the sale of shopping centers and has proven to be essential when interest rates are high by historic standards because legitimate economic transactions would not have occurred without it.

For this reason, ICSC's members are affected by the extension of the original issue discount (OID) rules to real property transactions and the revised imputed interest rules. ICSC has participated in efforts to resolve the problems with the new original issue discount and imputed interest rules (the "new rules") enacted by the Deficit Reduction Act of 1984. After the enactment of the new rules, ICSC testified before the Senate Finance Committee and participated in discussions with the Treasury, the Joint Committee on Taxation, and the Senate Finance Committee regarding amendments to the new rules.

However, ICSC did not support either of the products of these discussions: the so-called "Dole compromise" proposal and the interim rules which were enacted in mid-October, 1984. These proposals failed to solve the major problems that the new rules created for commercial real property transactions, did not resolve serious unfairness in applying certain of the new rules to certain common transactions, and were extremely complex.

ICSC is hopeful that the Committee can develop a more equitable permanent resolution of the issues concerning OID and imputed interest than either the new rules or the interim rules. ICSC also is hopeful that the Committee will be able to accomplish its stated objectives of avoiding taxpayer mismatching of interest income and deductions, restricting abusive tax shelters, and curtailing unintended tax benefits, without decreasing Federal revenues by effectively eliminating legitimate, economic real estate transactions that are not substantially tax-motivated and the capital gains taxes that result from such transactions.

II. The New Rules: A Flawed Solution

The objective of Congress in enacting the new rules was to curb abusive, tax-motivated deferred payment transactions. Some of the provisions of the new rules accomplish this objective without unduly interfering with legitimate, economic transactions. For example, the requirement that transactions under $2 million be accounted for under the cash method by both buyer and seller (presently applicable only to farm properties) and that transactions over $2 million be accounted for under the accrual method of accounting by both buyer and seller might prevent the mismatching of income and deductions. Although this provision will require that some taxpayers change their accounting system for deferred payment transactions, it is an appropriate method of preventing abuses. Another example of an appropriate change is the requirement that interest be calculated on a compounded basis in applying the test rate. We support this change because it reflects economic reality.

However, many other provisions of the new rules, in attempting to curb transaction perceived by Treasury to be abusive, would curtail many legitimate, economic transactions as well. This is primarily because of the excessive test rate selected to infer the fair market value of the property sold in a seller-financed transaction involving most commercial and rental residential real estate, i.e., 110 percent of the interest rate on federal debt obligations with maturities similar to the term of the seller-financed debt. This test rate bears no relationship to the fair market value of real property or to the actual market in non-tax-activated, seller-financed real property transactions. This is especially so when interest rates are high and changing rapidly, which accentuates the demand for seller-financed transactions. The unrealistically high test rate would stop seller-financed transactions from occurring in such circumstances.

In addition, the new rules fail to provide reasonably for assumptions and wraparounds, for contingent and variable rate loans, or for imputed non-deductible capital losses and interest.

These and other serious problems with the new rules must be solved before the rules can accomplish the objective of curbing abusive transaction without unduly restricting legitimate transactions.

III. Fundamental Problems With The New Rules

A. Background

The original issue discount (OID) and imputed interest rules of the tax law govern the timing of interest payment inclusions in and deductions from income and effectively set a minimum interest rate to be used in a seller-financed sale of property involving a debt instrument or deferred payments. Original issue discount arises when the borrower agreed to repay the lender (the redemption price). The difference between the redemption and issue prices, the OID, performs the same function as interest. The OID rules prevent the mismatching of income and deductions by governing the timing of the seller's inclusion in income and the buyer's deduction from income of the interest payment on debt instruments where OID is present.

Imputed interest rates arises where property is sold and the payment of all or a portion of the purchase price is deferred, resulting in a loan of the deferred amount. Imputed interest rules are intended to prevent the overstatement of principal and the understatement of interest by governing the measurement of principal and interest in deferred payment situations and specifying a minimum interest rate that must be used to avoid imputation of a higher interest rate.

Congress enacted new OID and imputed interest rules because of perceived abuses involving deferred payment transactions of property not traded on securities exchanges, and thus not subject to the OID rules. Congress was concerned that taxpayers were manipulating the principal amount of the debt by artificially fixing interest at a below-market rate. The alleged purposes of this perceived manipulation are to convert ordinary interest income into capital gains for the seller and to inflate the basis of the property in order to create excessive depreciation deductions and investment tax credits for the buyer.

As discussed above, in order to compute the amount of OID, the issue price of the debt must be known. Where the debt is issued for cash or a traded security, the issue price equals the amount of cash received or the listed price of the security. However, in transactions where the issuer receives nontraded property, the issue price is determined by the fair market value of the property sold. Because a case-by-case, "facts and circumstances" determination of fair market value was considered impractical, Congress chose to apply the OID and imputed interest rules to real estate and to determine value by applying the same test interest rates used to test the adequacy of interest payments under the imputed interest rules.

As explained by the Joint Committee on Taxation, the purpose of applying the test rate to a deferred payment transaction or nontraded property is to make "an approximation of the maximum fair market value of property (and hence the issue price of the obligation issued in exchange for it)' . . . by assuming a minimum rate of interest which parties dealing at arm's length and without tax motivations could be expected to agree upon." [1]

This minimum interest rate is set at 110 percent of the applicable federal rate (AFR) for transactions other than those involving principal residences, farms under $1 million, and other sales under $250,000, which are subject to a 9 percent test rate. The AFR is the average yield on federal obligations with maturities similar to the term of the loan. The stated rationale for this test rate is that this is "a reasonable approximation of the rate at which a good credit risk with adequate security would borrow.[2]

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[1] General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, Joint Committee on Taxation, 111.

[2] Id. at 115, n. 24.

B. Problems

1. The fair market value of real property cannot be determined solely from an examination of interest rates on Federal debt instruments

Parties to seller-financed real property transactions dealing at arms length and with no tax motivations generally agree on interest rates well below the test rates established by the new rules. This fact is not consonant with the intended operation of the new rules because the economic theory underlying the new rules is fundamentally flawed.

The relationship between interest rates and the fair market value of real property is more complex than the economic model which purports to support the new rules. The simple inverse relationship between interest rates and value, which the new rules presume, simply does not exist. In addition, over the range of interest rates of most importance under the new rules, when rates are high by historic standards, there is no relationship whatsoever between federal interest rates and the fair market values of real property.

a. Real property does not respond like a bond to changing interest rates because its essential financial attributes are completely different from the attributes of a bond

The new rules presume that real property is like a coupon bond, and that the value of real property is presumed to fluctuate inversely with interest rates just as do bond values.[3] A coupon bond provides a predetermined stream of payments over the life of the bond and a predetermined payoff at maturity. The value of the bond is the present value of that stream of payments, including the payoff at maturity. As interest rates rise, the future payments are discounted by a larger value and the present value of the bond consequently declines.

Real property would respond like a bond to changing interest rates only if the net operating income (the rental stream less operating costs) were predetermined over the life of the property and if the utlimate sale price of the property were predetermined. However, neigher the rental stream, nor the operating costs, nor the sale price of real property is predetermined and all are subject to inflactionary influences. This is why real property does not respond like a bond to changes in interest rates.

b. In the long run, changing interest rates affect rents and the stock of buildings rather than values

In fact, commercial real property responds to changing interest rates in a complex three-stage process that leads not to changing values, but to changing rents. In the short run, rents and the supply of buildings are effectively fixed, so changing interest rates tend to affect value. As interest rates fall, for example, value may increase (assuming that the buyer is free to mortgage with current market financing.) This change in value stimulates new construction, which increases the supply of buildings, which leads to lower rents, which in turn leads to a lower value approximating the original value. In the long run, therefore, the ultimate response to a reduction in interest rates is to increase the stock of buildings and reduce rents, but to leave values relatively unaffected.

c. When interest rates are outside the historic range of rates used in real property transactions, they have no effect on values

In addition, when market interest rates are abnormally high, which is when seller-financed transactions predominate because conventional financing is limited, there is absolutely no relationship between value and interest rates. Interest rates outside the historic range that the parties to the transaction consider likely to obtain in the long run have no effect on value because neither party uses them to discount future cash flows.

This is because real property is a relatively longlived asset which justifies the long-term loan commitments common to real property financing. Unlike perishable commodities, real property is not subject to forced sale other than in foreclosure situations. When interest rates rise, buyers and sellers make a judgment about the future, long-run interest rates that will occur over the life of the property and its financing. Temporary, aberrant high interest rates properly are ignored by the buyer and seller and an interest rate is negotiated that permits the sale to occur at a total compensation agreeable to the buyer and seller over the long run. The seller-financed interest rate is determined by long-run historic interest rates, which are the best indicator of long-run future rates, and not by temporary swings in interest rates or tax considerations.

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[3] See id.

In addition, even in the long run, changing interest rates do not produce changes in value beyond certain limits. This is clearly demonstrated by considering the situation when interest rates decline. The increase in the value of a building as interest rates decline is limited by a "ceiling" value generally equal to the cost of constructing an equivalent new building. The value cannot rise substantially above the ceiling regardless of how low interest rates go. Indeed, if the owner has a long term mortgage and is unable to prepay the loan and refinance at the new, lower rates (because of prepayment prohibitions or penalties), the value of the property to him may fall. This is because, as interest rates decline, competitors which newer, lower interest rate loans would have lower debt service costs and, therefore, could charge less rent, putting downward competitive pressure on his rents.

Similarly, when interest rates climb, the value of a building does not fall below a "floor" level regardless of how high interest rates go. The owner with an existing lower interest rate mortgage does not have increased interest costs. Indeed, he has an advantage over competitors with newer, higher interest rate loans and higher debt service because he can charge less rent then they can. This advantage may be passed along to a buyer through an assumption or wraparound of the original mortgage.

Therefore, the relationship between interest rates and real property values is very limited and exists almost solely in the short run, and this relationship only exists when interest rates are within a range deemed by the buyer and seller to be within the historic range of real property financing rates.

d. Interest rates play little part in determining the sale price of real property

Market interest rates play little part in determining the sale price of a property. This is because sellers cannot inflate the initial offering price for their properties without discouraging broker and buyer interest and because the seller-financing rate is not a primary factor in motivating the buyer or seller to reach agreement.

The most common method for selling real property is to list a property for sale at a price deemed appropriate by the seller. This price is not related to a seller-financing interest rate. Indeed, many listings recite as terms "cash or arrange", which means that the seller will sell for cash or will seller finance at the asking price. Listings where the intitial offer price (which can only be negotiated down, not up) has been inflated as a tradeoff for lower interest rates are most uncommon. Overpriced listings rarely receive the attention from brokers or buyers commonly shown to other listings.

The price paid for income producing real property, its fair market value, is determined by the motivations of the buyer and the seller. The major motivations involve the uses which the parties forsee for the property, their expectations about future cash flows and residual values, and emotional decisions (rational or irrational) such as decisions not to sell at a loss (even where there has been a reduction in value). The process of negotiating a sale is virtually always to first agree on a price and then to set the financing terms.

Only the boldest and most sophisticated sellers would even suggest a tax-motivated interest-price manipulation because of its complexity and because such an approach would discourage broker and buyer investigation and run counter to the normal negotiating procedure of setting price first and financing terms later. To assume that such a technique is common to the majority of seller-financed transactions clearly is contrary to experience in the marketplace.

2. Interest rates in seller-financed transactions are not related to Treasury interest rates

It is inappropriate to compare the interest rates the Treasury is forced to pay at any given time to the rates a seller can offer in a deferred payment transaction for the following reasons.

First, the seller may have underlying debt which was borrowed at an earlier time when rates were lower. Sellers have no need to go into the market to borrow funds to lend to buyers. Real property owners planning to sell their property forecast interest rate movements over the term of the buyer's note and would rarely be influenced by current rate levels of Treasury obligations. The sale price is often lower because the seller can allow the buyer to assume the existing favorable mortgage or can maintain the existing favorable mortgage in a "wraparound" transaction so that the overall rate charged to the buyer is reduced without decreasing the sellers' net interest yield expectations.

The Treasury is in a different situation. It must borrow, regardless of the prevailing interest rates, when it needs cash to fund the government's obligations. It has very little flexibility to stay out of the market when rates are abnormally high or to go into the market to take advantage of favorable rates.

Second, even if the seller and the Treasury (or other conventional lender) had the same cost of capital, the seller could still offer a lower interest rate on the deferred payment loan. This is because the risk of loss in such a transaction may be extremely low and there are lower transaction costs. Although the probability of default is greater for a debt obligation issued by the buyer than one issued by the Treasury, there may be very little risk of loss in a foreclosure situation because the loan is fully secured by the property sold, and the value of the property is known by the seller/lender. In addition, because it is not uncommon for the buyer to invest a substantial sum to renovate or upgrade a property after purchase, the property may be considerably more valuable upon foreclosure than it was at sale.

Third, the interest rate for debt issued by the seller may be less than for Treasury obligations because there are brokers' fees and other transaction costs associated with the purchase of the Treasury obligations, but not with seller-financed debt.

3. The AFR is not an appropriate index for determining a test rate because of its volatility; 110 percent of the AFR is not an appropriate test rate because it will stop seller financing in times of high interest rates

The AFR for short, medium, and long-term debt is extremely volatile and reaches peaks in times of high interest rates that are far above long-run historic interest rates. This volatility results in test rates that reach levels high enough to stop potential seller financing, particularly when market interest rates are high. The Treasury has issued new test rate regulations designed to minimize the "time lag" problem caused by differences between current market rates and the test rates based on Federal debt rates that occurred some time prior to the application of the test rate. Under these regulations, the test rate applicable to a loan is the lowest of the six-month average AFR or any of the three previous monthly AFRs. Currently, these rates range from 12.47 to 14.75 percent. All of these substantially different rates are above the level of interest rates currently generally available for income-producing commercial real property financing from third party lenders.

A test rate equal to 110 percent of the AFR stops transactions and deprives buyers and sellers of real property of an essential method of transferring property. It prevents properties from being transferred from a less to a more efficient use. It prevents the rehabilitation that often occurs when real property is sold. It reduces capital gains tax revenues. It interferes with private contractual relationships to an unreasonable and unjustified extent. And it raises the cost of financing, and therefore of operating, real property. This is particularly so during the periodic occurrences of abnormally high interest rates, when it deprives the economy of a needed safety valve by facilitating transactions when institutional loans are unavailable.

Most seller-financed real property transactions would be subject to the medium-term or long-term AFR. The relative volatility of such AFRs is demonstrated on the attached exhibits. Graph 1 compares the medium-term AFR, which has been approximately 40 basis points below the long-term AFR over the period of time covered by the currently applicable AFRs, to the Cost of Funds (COF) Index published by the Federal Home Loan Bank Board (FHLBB). Graph 2 depicts the relationship between 80 percent of the medium-term AFR (80 percent of the long-term AFR is approximately 40 basis points higher) and the COF Index.

C. General solutions

The lack of a predictable relationship between interest rates and the fair market value of real property is a fundamental problem that calls into question the entire structure of the new OID and Imputed Interest rules. This is why segments of the real estate industry have proposed repeal of the new rules. With the exception of the provisions which prevent the mismatching of interest income and deductions, we believe that repeal of the new rules is the best solution to the problems the new rules create for legitimate, non-tax-motivated transactions.

However, if this deeply flawed system is retained, it should be modified to minimize unintended economic dislocations. The rules should reflect the facts that any calculation of value based on interest rates will be imprecise, and that a variety of motivations influence sellers to dispose of real property at fair market values and to finance the sale at traditional, reasonable rates, rather than a desire to manipulate capital gains or to inflate basis for tax purposes. For these reasons, where a choice must be made between minimizing the possibility of abuse and minimizing interference with non-tax-motivated transactions, the latter course should be taken.

IV. Issues and Proposed Solutions

A. Selection of an appropriate test rate

As discussed above, 110 percent of the AFR is too volatile and frequently has resulted in interest rates too high to be used as a test rate. We believe that the test rate should be based on a more stable index and should in no case exceed the historical range of average interest rates used in real estate transactions.

In addition, there should be a "ceiling" on whatever test rate is employed, to prevent abnormally high levels of the test rate from stopping seller-financed transactions. As discussed above, fluctuating, aberrant, government-financing interest rates are ignored by buyer and seller in evaluating the sale price (value) of a property, and seller financing rates are more closely related to historic, long-run financing experience. A ceiling rate would apply this principle to the new rules. Establishing a ceiling rate also is appropriate in view of the 9 percent "floor" established by the rules.

We suggest that an appropriate ceiling would be the long-term, average capitalization rate on income-producing real property. The capitalization rate is the ratio of the current net operating income before debt service to the price. This ratio is a "rule of thumb" which is customarily calculated after the purchase has occurred and is then used to project the ultimate sale price of the property based on projections of net operating income over the expected holding period for the property. This ratio reflects the present value of future cash flows and residual values. Thus, the capitalization rate reflects the discount rate used to relate a present income level to a future sale price.

1. COF Index

We believe that one appropriate index is the Cost of Funds (COF) Index, and the appropriate test rate should not exceed 100 percent of the COF Index. The COF Index is much more stable than the AFR and is a reasonable approximation of usual seller-financed interest rates.

The COF Index is a close approximation of the rates actually used in real estate transactions. The COF Index is a weighted average of the cost of funds for institutions insured by the Federal Savings and Loan Insurance Corporation (FSLIC)—Savings and Loan Associations and Savings Banks. The sources of funds measured by this index are passbook savings accounts, certificates of deposit, and funds borrowed from the FHLBB. These funds are predominantly used to finance real property construction and acquisition.

The COF Index is less volatile than the AFR because S&Ls and savings banks have the flexibility of other private institutions and individuals in dealing with the financial markets. The ability of these private institutions to respond to changing interest rates and the supply of funds allows them to moderate the changes in their cost of funds.

For example, when an S&L expects rates to rise, it sells long-term CDs and seek to deter withdrawals through marketing and other means. When rates rise, the demand for loans drops and the S&Ls need to attract funds also drops. Therefore, higher interest rate borrowings form a lower proportion of the S&L's total borrowings. These actions keep their cost of funds (and the COF index) from rising as fast as other interest rates. As interest rates fall, new construction is stimulated and borrowing demand increases. This increased demand will keep the S&L's cost of funds from dropping as fast as other interest rates.

In seller-financed transactions, there are no loan origination costs ("points," origination fees, appraisal and mortgage title insurance fees, and commissions) and there is no profit for the seller in the loan portion of the transaction. For these reasons, the cost of funds for S&Ls is an appropriate measure of seller financing costs. Indexes which include these costs, such as the lending rates of S&Ls, would be approximately two points too high for a test rate.

2. Variable percentage of applicable Federal rate

If it is determined that the AFR must be the basis for the test rate, another option for improvement is to moderate the volatility of the AFR. This can be done by setting the test rate equal to a base rate plus some fraction of the difference between the AFR and the base rate.

For example, the test rate could equal 100 percent of the AFR at interest rates at or below 9 percent, and equal 9 percent plus one half of the difference between the AFR and 9 percent when the AFR exceeds 9 percent. Thus, if the AFR is 19 percent, the test rate would be 14 percent (9 percent plus one half of the 10 percent difference between 9 and 19 percent).

3. 80 percent of applicable Federal rate

Another option would be to set the test rate at 80 percent of the AFR. This approach is preferable to the present test rate because the peaks of 80 percent of the AFR that have been reached in the past when rates were increasing have generally been within the range of historically reasonable interest rates. Because of the AFR's volatility, however, there should be a cap on any test rate based on the AFR to account for extraordinary short-term fluctuations which bear little relationship to historic average interest rates over the term of the seller-financed debt.

4. Fixed 10 percent compounded test rate

Another approach would be to recognize that over a long period of time the capitalization rate used to calculate the value of commercial real property from operating income has been approximately 10 percent. This compounded 10 percent interest rate would be a significant increase over the 9 percent simple interest rate provided in the old Section 483 imputed interest rules.

5. Rates adjustable by the Treasury

Another approach is to reinstate the Section 483 test rate provisions applicable prior to the new rules, which rates were adjustable from time to time by regulation to reflect necessary changes due to changing market conditions.

B. Lower test rates or exemption from the rules for transactions that are not potentially abusive

Under the new rules, certain categories of property under certain levels of borrowings are subject to a 9 percent test rate rather than the 110 percent of AFR test rate. Under the interim rules, borrowings under $2 million are subject to the 9 percent test rate. We see no reason why the size of the borrowing or the nature of the property should create a presumption of tax abuse. While we have no objection to preferred treatment for certain types of property or for smaller transactions, we do feel that transactions that are not potentially abusive, without regard to their size or the nature of the property, also should be exempted or given preferred treatment. This would target potentially abusive transactions while minimizing the impact on other transactions.

We believe that a rational basis for excluding transactions from the rules or applying a test rate less likely to impair legitimate transactions is to exempt seller-financed transactions with attributes that make tax abuse impossible or extremely improbable. Based on the objectives of the OID and imputed interest rules, such attributes of seller financing are: (1) a relatively short maturity; (2) a relatively high percentage of interest paid currently; or (3) nondepreciable property.

One provision of the amendment that passed the Senate last year provided a lower test rate for seller-financed transactions with maturities less than ⅔ of the ACRS life (12 years) and with more than 80 percent of the interest paid currently. This type of transaction was deemed less likely to indicate an abusive transaction because of the relationship between depreciation and interest deductions. The "⅔ of the ACRS life and 80 percent of interest paid currently" test is reasonable and should be considered by the Committee.

Property that is not depreciable by the buyer, including personal use property such as residences and investments such as certain farms and raw land, also should be exempt from the rules or subject to a lower test rate because imputation would decrease federal revenues. Since real property depreciation is substantially limited to assets held for use in a trade or business or for production of income, and the investment credit is even more limited, there can be no excessive depreciation deduction or investment tax credit caused by basis inflation.

The increased federal revenues from exempting nondepreciable property from the rules would result because if there is no mismatch of interest income and deductions by the seller and buyer, the revenue effect caused by imputing interest income and deductions would be neutral, or even biased toward federal tax liability should the buyer be subject to investment interest deductibility limitations. In addition, the capital gains tax on disposition would be reduced if imputation recast the sale price downward.

Such an exemption from the rules also would remedy the inequitable consequences of the new rules regarding nondeductible capital losses of investment assets, as discussed in part "F" below.

C. Equitable treatment of variable and contingent rate loans

The new rules strongly discourage the use of variable and contingent rate loans. The interest rate of a variable rate loan is keyed to an index such as Consumer Price Index or a Federal rate. The actual interest rates over the term of the debt cannot be determined at the time of sale when the test is applied. Contingent rate loans have additional interest payments that are dependent on the amount of net operating income. The interest payments in such loans cannot be estimated when the transaction occurs and, therefore, the test rate is applied only to the base interest rate. The base rate is set lower than other market interest rates to take account of the cash flows of the buyer over time. Applying the test rate to the base rate biases the test against these common types of loans.

This problem is further evidence of the fundamental flaw in the underlying basis for the new rules: the erroneously assumed relationship between value and interest rates. Value cannot be inferred from interest rates in such transactions.

We urge Congress to develop workable solutions to the problem of fairly treating these transactions under the rules.

D. Related third party debt: Assumptions and wraparounds

For the purposes of these rules, which are unique in the Internal Revenue Code because they use interest rates to infer the fair market value of real property, we believe that related third party debt (assumed debt, debt taken subject to, and the existing debt portion of a wraparound loan) should not be subject to the rules. Only new seller-financed debt and the new debt portion of a wraparound debt should be subject to the test.

This is because the purpose of the OID and imputed interest rules is to stop buyers and sellers from tailoring interest rates for tax-motivated reasons and charging inadequate interest. Debt that is assumed, or taken subject to, on the existing debt portion of a wraparound transaction cannot be tailored because their terms are fixed before the transactions between the buyer and seller takes place. In addition, such debt either would have been issued before the new rules were in place or would have passed the test when originally loaned.

Additionally, if the Treasury's announced reason for requiring sellers to charge interest rates comparable to those which institutional lenders would charge were a valid basis for the new rules, then sellers should not be required to charge a greater rate than institutional lenders would charge on the portion of the wraparound loan provided by the seller. When underlying third-party financing exists which can be maintained or assumed, then the seller's required test rate should apply only to the seller's equity.

Accordingly, in the case of an assumption, the rate should apply solely to net financing provided by the seller, exclusive of assumed third-party financing.

In the case of wraparound financing (whether by all-inclusive mortgage, contract of sale, contract for deed, etc.), the test rate should be applied to the interest rate on the seller-financed debt, calculated by comparing the seller's equity in the wraparound loan (the amount by which the principal amount of the loan exceeds the balance of the underlying debt) and the interest payments retained by the seller after paying out to the third party lender the interest payments on underlying debt. For example, assume that the principal amount of the wraparound note is $1,000,000 and the interest rate on the note is 12 percent, the balance on the seller's existing underlying third-party debt is $500,000 bearing interest at 6% per annum, and the maturity of the wraparound loan equals the remaining maturity of the underlying debt. Under these circumstances, the interest rate on the new debt portion of the wraparound note is 9 percent, and this is the rate that should be subject to the test rate. Either an institutional third-party lender who deals in wraparound financing or a seller would provide the additional lending over the balance of the existing debt in this manner.

In addition, it is ludicrous to impose restrictions which penalize sellers for retaining and passing on to buyers the benefits of long-term financing previously bargained for when the existing financing was undertaken. Such restrictions greatly discourage assumptions and wraparound and inflate the cost of real estate (by increasing debt service) for the sole benefit of underlying third-party lenders. Such provisions also unfairly penalize borrowers under long-term financing where there is a prohibition against or penalty for prepayment. Such sellers would be deprived of the benefit of using the debt for an assumption or wraparound loan at an interest rate lower than current market rates, but would continue to suffer the detriment of bearing the risk that they will be locked-in to long-term market rates if interest rates decline.

E. Mismatch prevention

As we discussed above, we support changes intended to stop the mismatching of income and deductions of taxpayers with different accounting periods. We believe that requiring cash basis accounting for smaller transactions and accrual accounting for larger transactions is a reasonable approach. However, we believe a better solution would be to require both the buyer and seller to use their existing accounting method if they are the same, and require both the buyer and seller to use cash accounting in smaller transactions and acrual accounting in larger transactions.

F. Problems associated with imputation of interest

1. Capital losses on investment assets

The "new rules" fail to consider the great inequity which would result to sellers of "investment assets" if interest payments above contract amounts are imputed. Some farmers and other sellers of non-productive investment assets (§ 1221 capital assets) whose property values have decreased might have nondeductible net capital losses (totally non-deductible for corporate sellers and non-deductible over $3,000 per year for non-corporate sellers).

The imputation of higher than contracted rates to such transactions would increase the non-deductible net capital losses of the sellers by recasting a lower sale price while increasing the taxable interest income without actual increases in income of the seller already suffering from his capital loss.

This inequity should be resolved either by: (1) Providing for no imputation if it would create or increase a capital loss on investment assets; or (2) Providing that net capital losses will be treated as net § 1231 losses, or as other ordinary loss deductions, to the extent of any capital loss resulting from sale price recasting due to imputed interest.

2. Imputed interest deductibility

Treasury has stated its intent to avoid mismatching, i.e., to have equality of interest income and deductions, between the buyer and seller. However, the application of the existing "investment interest" limitations might destroy such equality by disallowing a portion of buyer's interest payment as a current deduction.

This inequality should not be accentuated by the imputation of additional interest expense to the buyer who may not deduct it. Imputed interest should be currently deductible by the buyer regardless of existing investment interest limitations.

Similarly, Congress should repeal Section 1275(b), which would limit imputed interest deductions related to the purchase of personal-use property.

3. Imputation rate

The imputation rate whould be the same as the test rate because the rules are likely to be complex enough to constitute a trap for the unwary, because it is questionable whether exceeding any test rate indicates anything about either tax motivation or tax impact, and because this will bias financing away from sellers and toward institutional lenders.

G. Revenues

Revenue estimates for the new rules have been published. However, it is our understanding that these are based on the output of static econometric models that ignore the likely consequent reduction in transaction activity and in capital gains taxes paid caused by the new rules. In times of high interest rates, meeting the 110 percent of AFR test rate would increase debt service costs in most transactions to the point that rents would not carry them. Sales would not occur in this situation.

We believe that, rather than a revenue increase resulting from the curbing of abuses by the new rules, there would be significant revenue reductions as legitimate transactions are deterred and capital gains tax receipts are reduced.

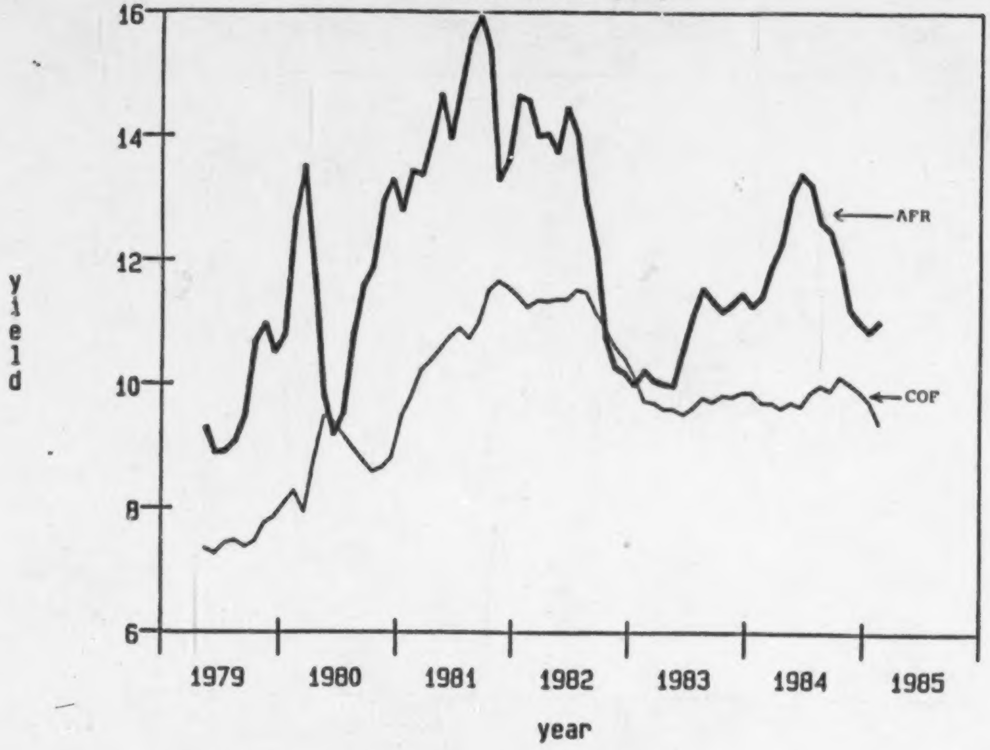
We further believe that it is improper to invoke the principal of revenue neutrality in a situation where the calculated revenue gain is due to a flawed analysis. The fact is that the new rules will prohibit many legitimate transactions.

V. Conclusion

The ICSC believes that the new OID and imputed interest rules must be substantially amended if they are to meet their objective of curbing potential abusive deferred sales transactions without interfering with the use of seller financing as a valid method of financing real property sales in times of high interest rates. Specifically, changes are needed to remedy problems with the index used for the test rate, with the level of the test rate, with the treatment of variable and contingent rate loans and assumptions and wraparounds, with the treatment of capital losses on investment properties, and with the treatment of buyers' imputed interest deductions.

GRAPH 1

APPLICABLE FEDERAL RATE, MID-TERM MATURITY
(U.S. TREASURY 3-9 YR. MATURITY) (bold);
AND FHLBB COST OF FUNDS (line)



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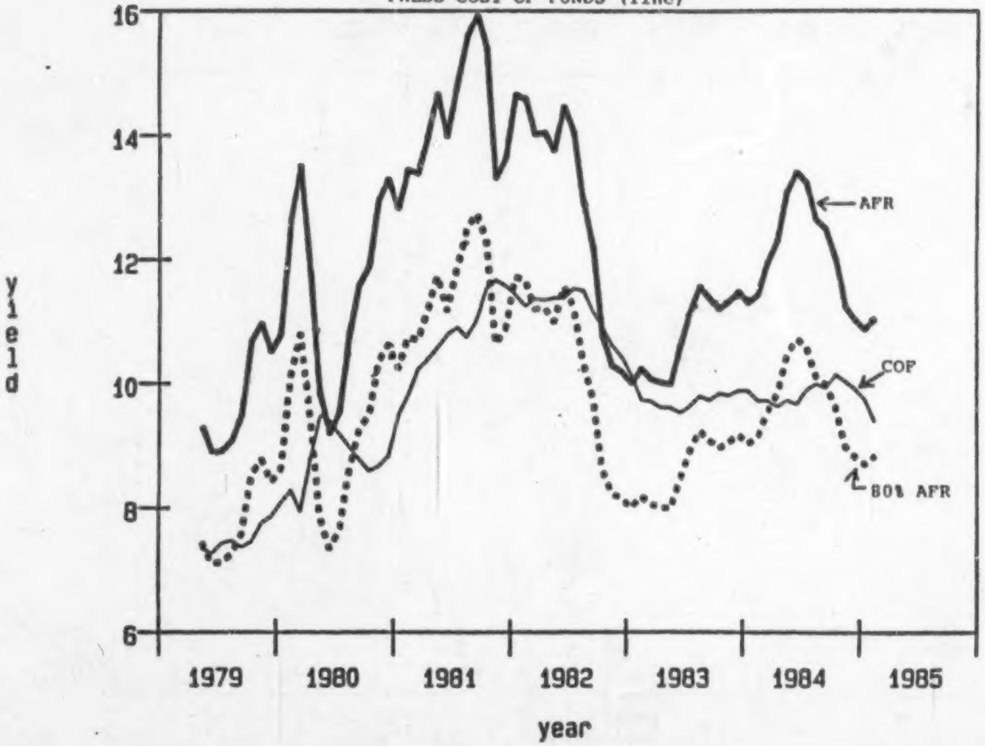
GRAPH 2

100 PERCENT (bold) AND 80 PERCENT (bold, dotted) OF THE APPLICABLE FEDERAL RATE, MID-TERM MATURITY (U.S. TREASURY 3-9 YR. MATURITY) AND FHLBB COST OF FUNDS (line)



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Mr. **Matsui**. Thank you, Mr. Woodbury.

Mr. Simpson.

Mr. Woodbury, without objection, we will put your entire comments in the record.

STATEMENT OF RONALD L. SIMPSON, PRESIDENT, BUILDING OWNERS & MANAGERS ASSOCIATION INTERNATIONAL

Mr. **Simpson**. Mr. Chairman, thanks for the opportunity to be here today and, in the interest of time and maybe some redundancy, I would ask that our written remarks be incorporated.

Mr. **Matsui**. Without objection.

Mr. **Simpson**. My name is Ronald L. Simpson. I am president of the Building Owners & Managers Association International.

I earn my living as a broker, specializing in leasing in Denver, CO.

I would like to review some of the points within our written testimony. The Building Owners & Managers Association International supports the provisons of the new original issue and imputed interest rules that prevent the mismatching of interest income and deductions. However, other provisions of the new rules would effectively end the use of seller financing for larger office buildings in times of high interest rates, thus seriously disrupting the office building industry.

BOMA believes that the OID and imputed interest rules are fundamentally flawed because they rely on presumed relationships between market interest rates and the value of real property. This relationship does not exist other than in the short term. And, even in the short term it does not exist when interest rates are in excess of the long-term historic range of interest rates used to finance real property.

In addition, the use of the test rate prescribed in the rules—110 percent of the AFR—would essentially stop seller financing in times of high interest rates, precisely when it is most needed to allow real estate transactions to occur. For these reasons, BOMA believes that the best solution to the problems created by the new rules is to repeal them.

However, if the rules will continue to use interest rates to test seller-financed transactions, then we strongly urge that the following changes be made.

The test rate should be based on the Federal Home Loan Bank Board's cost of funds, the COF Index, rather than the AFR, and should be no higher than 100 percent of the COF Index. It is much more stable than the AFR and its level generally approximates historic interest rates used in seller-financed transactions.

The test rate should have a ceiling designed to prevent increases in the test rate from stopping seller financing in times of abnormally high interest rates.

If the test rate must be based on the applicable AFR, then it should be set up at no more than 80 percent, and should be subject to a ceiling rate.

Out there in the real world in office buildings, a $2 million exemption is simply not applicable. A $2 million exemption is what equates to approximately 18,000 square feet, about the size of a small supermarket or maybe the size of this room. That has no bearing in the office building industry it seems.

What is important, I will agree with previous testimony, is the test rate. We all learned from the experiences of 1982 and 1983 what high interest rates can do to a real estate economy. It stops construction. It causes a shrinking marketplace. It increases rents artificially as a result of supply and demand. It certainly slows down sales and, as a result, increases the need for seller financing.

Seller financing rates are determined by several things: Cash requirements of the sale, the credit worthiness of the buyer; and the time of repayment. In periods of high interest rates, or a depressed market, seller financing becomes a fundamental marketing tool in order to dispose of the property.

If the seller is required to use a higher rate, the buyer becomes discouraged and no sale takes place. The seller, in order to sell, must reduce the purchase price, and that is where the rub is. And, gentlemen, I would like to explain that in the majority of the cases affecting BOMA members, and, certainly, the office building industry, we have to remember who the sellers are—they are not faceless names in a back room. They are family owned properties. There are family trusts, there are pension funds, real estate investment trusts, independent developers who are depending upon the ability to buy and sell property at will and not having inflated interest rates to deal with.

Tax revenues, as previously stated, will in our opinion decline simply because there are not going to be any sales. The sales will be changed drastically.

Market value, in our opinion, is not determined by appraisals or comparable values, as the question was asked earlier. It is determined by what someone is willing to pay, the terms offered, and being given the proper time to market the property. Seller financing is as attractive for the seller as is collateral for the property itself. Thus, the risk of making a bad loan is usually less than that of a lending institution, thus the lesser rates.

Unless the legislation is changed, Congress, in our opinion, would be requiring unrealistic and unwarranted rules for property owners that would seriously handicap their ability to sell and could cause a serious reduction in future construction.

Thank you.

[The prepared statement follows:]

STATEMENT OF RONALD L. SIMPSON, PRESIDENT, BUILDING OWNERS & MANAGERS ASSOCIATION INTERNATIONAL

SUMMARY

The Building Owners and Managers Association International (BOMA) supports the provisions of the new original issue (OID) and imputed interest rules that prevent the mismatching of interest income and deductions. However, other provisions of the new rules would effectively end the use of seller-financing for larger office buildings in times of high interest rates, thus seriously disrupting the office building industry.

BOMA believes that the OID and imputed interest rules are fundamentally flawed because they rely on the presumed relationship between market interest rates and the value of real property. This relationship does not exist other than in the short run, and even in the short run it does not exist when interest rates are in excess of the long-run historic range of interest rates used to finance real property.

In addition, the use of the test rate prescribed in the rules—110 percent of the applicable Federal rate—would essentially stop seller financing in times of high interest rates, precisely when it is most needed to allow real estate transactions to occur. For these reasons, BOMA believes that the best solution to the problems created by the new rules is to repeal them.

However, if the rules will continue to use interest rates to test seller-financeed transactions, then we strongly urge that the following changes be made.

1. The test rate should be based on the Federal Home Loan Bank Board's Cost of Funds (COF Index), rather than the Applicable Federal Rate (AFR), and should be no higher than 100 percent of the COF Index. It is more stable than the AFR and its level generally approximates historic interest rates used in seller-financed transactions.
2. The test rate should have a ceiling designed to prevent increases in the test rate from stopping seller financing in times of abnormally high interest rates. This ceiling rate should be related to the long-run range of capitalization rates used to calculate value based on current operating income.
3. If the test rate must be based on the applicable federal rate (AFR), it should be set at no more than 80 percent of the AFR and should be subject to the ceiling rate described above.
4. In addition to applying less stringent test rates to certain types of property, the rules also should provide this treatment to transactions that have attributes which make abuse impossible or extremely improbable, i.e., obligations with relatively short maturities and relatively high percentables of interest paid currently, or transactions involving nondepreciable property.
5. Variable and contingent interest rate loans should not be strongly discouraged by rules that consider only the base interest rate when applying the test. Some fair method for testing such increasingly common transactions must be found.
6. Assumed debt and the existing debt portion of wraparound obligations should not be subject to the test. Such debt would already have passed the test when originally issued and cannot be tailored to the circumstances of the buyer and seller.
7. When both buyer and seller use the same accounting method, they should be allowed to use this method for seller-financed transactions. When either uses accrual accounting, this method should be required for both.
8. The imputation rate should be the same as the test rate.

STATEMENT

I. Introduction

My name is Ronald L. Simpson. I am the President of the Building Owners and Managers Association International (BOMA). Also, I am the President of Ron Simpson & Associates and the president of Leasing Consultants, Inc. These companies lease office space for owners and developers on a customized basis. I am presenting this testimony on behalf of the members of BOMA International.

BOMA is the trade association representing the office building industry through over 90 local associations located in the United States, Canada, and nine other countries. Its more than 5,500 members are office building developers, owners, managers, service companies, and investors, who control over two billion square feet of class "A" office space, or one fourth of the office space in North America.

A. The office building industry

The office building industry provides an essential service to the entire economy—space for its managers and other white collar employees to work. It has been estimated that in 1985 there are over 700,000 office buildings with 9.5 billion square feet of office space. An estimated 42 million persons are working in office buildings now. This is 40 percent of the U.S. workforce and over 70 percent of the white collar workforce.

In addition, the office building industry contributes directly to GNP and employment via office building staff and service companies. An estimated 5.3 million persons are employed by these buildings in management, maintenance, custodial and other positions. This amounts to 5 percent of U.S. employment, with a building employee payroll of $12.1 billion. An additional $14.5 billion of economic activity is generated through contract building services and another $4.9 billion will be generated by other building expenditures. The cost of operating office buildings is thus about one percent of U.S. GNP.

Furthermore, the value of new office buildings constructed just last year was $26 billion—0.7 percent of total U.S. GNP. This construction provided over one half million full-time jobs.

B. Involvement in the office building industry in the resolution of the imputed interest issue

Office buildings are often sold in transactions involving financing by the seller. This method of financing the sale of office buildings is particularly important when interest rates are high. From 1977 through 1982, for example, many office buildings were sold with seller financing, just as many private homes were, and for the same reason—artificially high interest rates were preventing economic transactions from occurring without seller financing.

For this reason, BOMA has been interested in the original issue discount (OID) and imputed interest rules and has participated in efforts to resolve the problems with the O.I.D. and imputed interest rules enacted by the Deficit Reduction Act of 1984 (the "new rules"). After the enactment of the new rules, BOMA submitted a statement to the Senate Finance Committee urging the Committee to repeal or revise the new rules.

BOMA did not support the Finance Committee's so-called compromise proposal because the proposal failed to solve the major problems that the new rules created, did not resolve important issues in applying the rules to common transactions, and was extremely complex.

BOMA is hopeful that the Committee can develop a permanent resolution of the imputed interest issue that accomplishes the Committee's stated objectives of restricting abusive tax shelters and curtailing unintended tax benefits, but without causing economic dislocations by effectively prohibiting legitimate, economic, seller-financed real estate transactions that are not tax-motivated rates.

II. The New Rules

Congress enacted the new imputed interest rules to curb abusive, tax-motivated deferred payment transactions. Some of the provisions of the new rules accomplish this objective without unduly interfering with legitimate, economic transactions. For example, we support the requirement that transactions under $2 million be accounted for under the cash method by both buyer and seller (presently applicable only to farm properties) and that transactions over $2 million be accounted for under the accrual method of accounting by both buyer and seller. These provisions will prevent the mismatching of income and deductions.

However, other provisions of the new rules would curb not only abusive transactions, but also many legitimate, economic, non-tax-motivated transactions as well. The major problem is the interest rate selected under the new rules to test the adequacy of the interest payments—110 percent of the yield on federal debt obligations with maturities similar to the term of the seller-financed debt. This test rate bears no relationship to the real market interest rate for real estate loans, especially when interest rates are high and erratic. This is when seller-financed transactions predominate. The test rate would stop seller-financed transactions from occurring in such circumstances.

This and other serious problems with the new rules must be solved before they can accomplish the objective of curbing abusive transactions without unduly restricting legitimate deferred payment transactions.

III. Fundamental Problems With the New Rules

A. Background

The original issue discount and imputed interest rules of the tax law govern the timing of interest payment inclusions in and deductions from income. They effectively set a minimum interest rate to be used in a sale of property involving a debt instrument or deferred payments. Original issue discount arises when the borrower agrees to repay (the redemption price) the lender more than he originally borrowed (the issue price). The difference between the redemption and issue prices—the OID—performs the same function as interest. The OID rules prevent the mismatching of income and deductions by governing the timing of the seller's inclusion in and the buyer's deduction from income of the interest payment on debt instruments where OID is present.

Imputed interest arises where property is sold and the payment of all or a portion of the purchase price is deferred, resulting in a loan of the deferred amount. The imputed interest rules prevent the overstatment of principal and the understatement of interest by governing the measurement of principal and interest in deferred payment situations and specifying a minimum interest rate that must be used to avoid imputation by the IRS of a higher interest rate.

The new OID and imputed interest rules were enacted because of perceived abuses involving deferred payment transactions of property not traded on securities exchanges, and thus not subject to the old OID rules. Congress was concerned that taxpayers were manipulating the principal amount of the debt by artificially fixing interest at a below-market rate. The supposed purpose of this manipulation is to convert ordinary interest income into capital gains for the seller, and to inflate the tax basis of the property in order to create excessive depreciation deductions and investment tax credits for the buyer.

In order to compute the amount of OID, the issue price of the debt must be known. When a note is issued for cash, the issue price equals the amount of cash received. When a note is issued for property traded on a securities exchange, the issue price equals the listed price of the property. However, in transactions in which the issuer receives nontraded property, the issue price is determined by the fair market value of the property sold. Because a case-by-case, "facts and circumstances" determination of fair market value was considered impractical, Congress chose to determine value by incorporating into the OID rules the test for adequate interest formerly contained in the imputed interest rules.

The test rate is applied to a deferred payment tranasaction to make "an approximation of the maximum fair market value of property (and hence the issue price of the obligation issued in exchange for it) . . . by assuming a minimum rate of interest which parties dealing at arm's length and without tax motivations could be expected to agree upon." [1] This minimum interest rate was set at 110 percent of the applicable federal rate (AFR), which is the average yield on federal obligations with maturities similar to the term of the loan.

B. Problems

1. The fair market value of real property cannot be determined solely from an examination of interest rates

The new OID and imputed interest rules are fundamentally flawed because the economic model which supports them is oversimplified and inaccurate. The presumed relationship between interest rates on federal obligations and fair market value does not exist, especially when rates are high by historic standards.

The economic model which supports the new OID and imputed interest rules is oversimplified and inaccurate because it assumes that real property is like a coupon bond, the value of which fluctuates inversely with interest rates.

A coupon bond provides a fixed stream of payments over the life of the bond. The value of the bond is the present value of that stream of payments. As interest rates rise, the future payments are discounted by a larger value and the present value of the bond consequently declines.

Real property would respond like a bond to changing interest rates only if this rental stream were fixed over the life of the property. But this is not the case since rental streams are not fixed over the life of the property.

Commercial real property responds to changing interest rates in a process that leads in the long run not to changing values, but to changing rents. In the short run, rents and the supply of buildings are effectively fixed, so changing interest rates affect value. As interest rates fall, for example, value may increase. However, this change in value stimulates new construction, which increases the supply of buildings which leads to lower rents, which then lowers values to approximately the original level. The ultimate response to a reduction in interest rates, therefore, is to increase the stock of buildings and reduce rents, but to leave values relatively unaffected.

In addition, when rates are abnormally high, which is when seller financing predominates, or when rates are abnormally low, there is absolutely no relationship between value and interest rates. Interest rates outside the historic range that the parties to the transaction consider likely to prevail in the long run have no effect on value because neither party uses them to discount future cash flows. When interest rates rise, buyers and sellers of real property make a judgment about future, long-run interest rates that will occur over the life of the property. Temporary, aberrant high interest rates are properly ignored and an interest rate is negotiated that permits the sale to occur at a total compensation agreeable to both buyer and seller over the long run. The interest rate used in a seller-financed transaction is determined by long-run historic interest rates, which are the best indicator of long-run future rates, and not by temporary swings in interest rates or by tax considerations.

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[1] General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984. Joint Committee on Taxation, 111.

Therefore, the relationship between interest rates and real property values exists almost exclusively in the short run, and this relationship only exists when interest rates are within a range deemed by the buyer and seller to be reasonable in the long run.

2. The AFR is an inappropriate test rate index because the seller's cost of funds for financing a sale is not the same as the treasury's cost of funds

There is little relationship between the interest rates the Treasury is forced to pay at any given time and the rates a seller can offer in a deferred payment transaction. One reason is that when interest rates are high, sellers are not in the market borrowing funds to lend to buyers at lower rates. Real property owners planning to sell their property forecast interest rate movements over a period of years and may refinance their properties at favorable rates. The seller can often allow the buyer to assume the existing mortgage or can use the existing mortgage in a "wraparound" transaction when interest rates are higher at a later date.

However, the Treasury is in a different situation. It must borrow, regadless of the prvailing interest rates, when it needs cash to fund the government's obligations. It has very little flexibility to stay out of the market when rates are abnormally high or to go into the market to take advantage of favorable rates.

Another reason is that even if the seller and the Treasury have the same cost of capital, the seller can still offer a lower interest rate than the Treasury on a deferred payment loan. This is because there may be very little risk of loss in such a transaction and there are lower transaction costs. Although the probability of default is greater for a debt obligation issued by the buyer than for one issued by the Treasury, there may be little risk of loss in a forclosure situation because the loan is fully secured by the property sold and the value of the property is known by the lender. In addition, because it is not uncommon for the buyer to invest a substantial sum to renovate a property after purchase, the property may be considerably more valuable upon foreclosure than it was at sale.

A third reason for the difference between Treasury and seller financing interest rates is that the interest rate for debt issued by the seller may be less than for Treasury obligations because the brokers' fees and other transaction costs that are associated with the purchase of the Treasury obligations are not involved in seller-advanced debt.

3. 110 percent of the AFR is not an appropriate test rate because it will stop seller financing in times of high interest rates

The AFR for short, medium, and long-term debt is extremely volatile, and 110 percent of the AFR reaches peaks in times of high interest rates that are far above long-run historic interest rates. The volatility of the medium-term AFR, which is most likely to be applicable to seller-financed real estate transactions, is compared to the relative stability of the Cost of Funds (COF) Index published by the Federal Home Loan Bank Board (FHLBB) in Graph 1, attached.

The volatility of the AFR results in test rates that reach levels high enough to stop seller financing when market interest rates are high. Under the new rules and the implementing regulations, the test rate applicable to a medium-term loan is the lowest of the six-month average AFR or one of three previous monthly AFRs. Currently, these rates range from 12.47 to 14.75 percent. All of these rates are above current interest rates available from third party lenders.

The test rates prescribed by the new rules deprive buyers and sellers of real property of an essential method of transferring property during occurrences of abnormally high interest rates. They deprive the economy of a needed safety valve at such times. They prevent properties from being transferred from a less efficient to a more efficient use. They prevent the rehabilitation that often occurs when real property is sold. They reduce capital gains tax revenues. Also, they interfere with private contractural relationships to an unreasonable and unjustified extent. We believe that these unintended adverse effects far outweigh any benefits that may derive from curbing the relatively few tax-motivated seller-financed transactions.

C. Solutions

The fact that there is no predictable relationship between interest rates and the fair market value of real property calls into question the entire structure of the new

OID and imputed interest rules. These rules simply do not accomplish their purpose, the curbing of tax abuses without stopping non-abusive transactions.

This is why segments of the real estate industry have proposed repeal of the new rules. Indeed, with the exception of the rules to prevent mismatching of interest income and deductions, we continue to believe that repeal of the new rules is the best solution to the problems the new rules create for legitimate, non-tax-motivated transactions.

However, if the new rules will continue to use interest rates as a measure of fair market value, they should be modified to minimize unintended economic dislocations. The new rules should reflect the fact that any calculation of value based on interest rates will be imprecise. Seller-financed transactions are overwhelmingly motivated by a desire to deal with abnormally high interest rates rather than a desire to manipulate capital gains or to inflate basis for tax purposes. For these reasons, where a choice must be made between minimizing the prevention of abuse and minimizing the interference with non-tax motivated transactions, the later course should be taken.

IV. Problems and Solutions

A. The test rate

The current test rate applicable to large transactions—110 percent of the AFR—is too volatile and often too high to be used as a test rate. We believe that the test rate should be based on a stable index and should not exceed the historical range of interest rates used in real estate transactions.

We believe that the appropriate index is the Cost of Funds Index and the appropriate test rate should not exceed 100 percent of the COF Index. The COF Index is more stable than the AFR and is a close approximation of usual seller-financed interest rates. This is because it reflects the true costs of seller-financed transactions.

The COF Index is a weighted average of the cost of funds for institutions insured by the Federal Savings and Loan Insurance Corporation (FSLIC) (Savings and Loan Associations and Savings Banks). The sources of funds are passbook savings accounts, certificates of deposit, and funds borrowed from the FHLBB. These funds predominantly are used for real property construction.

The COF Index is less volatile than the AFR because S&Ls and savings banks have a flexibility in dealing with the financial markets that the Treasury lacks. This flexibility allows them to minimize changes in their cost of funds by altering their borrowing and lending patterns as interest rates and the supply of funds change.

In seller-financed transactions, there are no loan origination costs ("points," appraisal and title insurance fees, or commissions) and there is no profit for the seller in the loan portion of the transaction. For these reasons, the cost of funds for S&Ls and savings banks is an appropriate measure of seller financing costs. Indices which include these extra costs, such as the lending rates of S&Ls and savings banks, would be approximately two points too high for an appropriate test rate for seller financing.

In addition, there should be a "ceiling" on the test rate to prevent temporary, aberrant levels of the COF Index from stopping seller-financed transactions. As discussed above, aberrant interest rates outside long-run historic interest rates are ignored by buyer and seller in evaluating the value of a property. A ceiling rate would apply this principle to the test rates.

Establishing a ceiling rate also is appropriate in view of the 9 percent "floor" established by the rules. This would provide symmetric treatment and establish the range of relevant, historic interest rates used in real property transactions.

Also, we believe that the "capitalization rate" (net income/purchase price), which represents the overall yield on current income from real estate, should be considered in setting the ceiling rate. This is the rate customarily used to relate value to current income.

However, if the test rate must be based on the AFR, it should not exceed 80 percent of the AFR. This level is preferable to the present test rates because the peak levels of 80 percent of the AFR that have been reached in the past have generally been within the range of historically reasonable interest rates. The COF Index and 80 percent of the AFR are compared in Graph 2, attached. This graph shows that 80 percent of the AFR generally gyrates above and below the COF Index by relatively equal amounts. In addition, there should be a cap on any test rate based on the AFR to account for future Treasury rates in excess of those that have occurred in the past.

B. Exemptions from the rules

Under the new rules, certain categories of property under certain levels of borrowings are subject to a 9 percent test rate. Under the interim rules, borrowings under $2 million are subject to the 9 percent rate. The properties owned by our members are not in a favored category and have values far exceeding any threshold level under consideration. We see no reason to have a higher test rate for office buildings with borrowings over $2 million. While we have no objection to an exemption or preferred treatment for certain categories of property or for smaller transactions, we do feel that transactions that are not potentially abusive also should be exempted from the rules or given preferred treatment without regard to their size or nature. This would target potentially abusive transactions while minimizing the impact on other transactions.

A rational basis for accomplishing this would be to specify the attributes of a seller-financed transaction that make tax abuse impossible or extremely improbable. Based on the objectives of the OID and imputed interest rules, the attributes of seller-financed transactions with little or no potential for abuse are: (1) a relatively short maturity; (2) a relatively high percentage of interest paid currently; or (3) nondepreciable property.

The amendment that passed the Senate last year contained a provision that set a lower test rate for seller-financed transactions with maturities less than 2/3 of the ACRS life (12 years) and with more than 80 percent of the interest paid currently. This type of transaction was deemed less likely to indicate an abusive transaction because of the relationship between depreciation and interest deductions. The "2/3 of ACRS life and 80 percent paid currently" test is reasonable and should be considered by the Committee.

Property that is not depreciable by the buyer, such as raw land and structures not used in a trade or business, should be exempt from the rules or subject to a lower test rate because there can be no excessive depreciation or deduction caused by basis inflation. By exempting nondepreciable property, all residences and farm land would be exempted.

C. Variable and contingent rate debt

The new OID and imputed interest rules strongly discourage the use of variable and contingent rate loans. Variable rate loans are keyed to an index such as the Consumer Price Index or a Federal rate. Contingent rate loans have additional interest payments that are dependent on the amount of net operating income. The interest payments on such loans cannot be estimated when the transaction occurs, and the test rate is therefore applied only to the base interest rate. The base rate is set lower than other market interest rates to take account of the cash flows of the buyer over time. Applying the test rate to the base rate biases the test against these common types of loans.

This problem is further evidence of the fundamental flaw in the underlying basis for the new rules—the assumed relationship between value and interest rates. Value cannot be inferred from interest rates in such transactions.

We urge Congress to develop workable solutions to the problem of fairly evaluating these transactions under the rules.

D. Assumptions and wraparounds

The OID and imputed interest rules are unique in the Internal Revenue Code because they use interest rates to infer fair market values of real property. For the purpose of these rules, we believe that all assumed debt, and the existing debt portion of wraparound debt, should not be subject to the rules. Only the new debt portion of a wraparound debt should be subject to the test.

This is because the purpose of the OID and imputed interest rules is to stop buyers and sellers from tailoring interest rates for tax-motivated reasons and charging inadequate interest. Debt that is assumed, taken subject to, or used in a wraparound transaction cannot be tailored, since its terms are fixed before the transactions between the buyer and seller take place.

In addition, such debt either would have been issued before the new rules were in place or would have passed the test when originally loaned.

E. Mismatch prevention

As discussed above, we support rules which will stop the mismatching of income and deductions of taxpayers with different accounting methods. We believe that requiring cash accounting for smaller transactions and accrual accounting for larger transactions is an acceptable solution. However, we believe a better solution would be to allow the parties to use either system if both parties already use one or the other and to require them both to use accrual accounting if either party uses this method.

F. Imputation rate

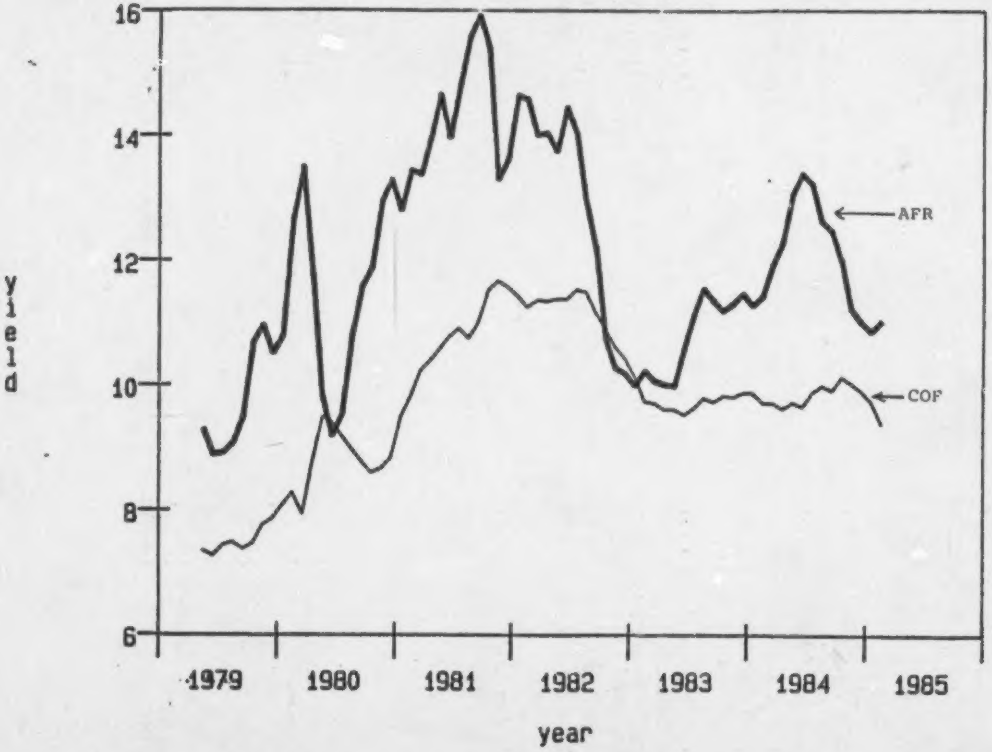
Since the purpose of the test rate is to determine the fair market value of property and insure that this value is used for tax purposes, we believe that the imputation rate should be the same as the test rate. Once an interest rate is determined to result in some approximation of fair value, the rules should operate to insure the adequacy of this value, not to provide a penalty.

V. Conclusion

BOMA believes that the new rules should be repealed, with the exception of the provisions that prevent the mismatching of income and deductions. However, if the new rules will continue to use interest rates to measure fair market value, we recommend that the rules be substantially modified so as to minimize the economic dislocations caused by interference with legitimate, economic seller-financed transactions.

GRAPH 1

APPLICABLE FEDERAL RATE, MID-TERM MATURITY
(U.S. TREASURY 3-9 YR. MATURITY) (bold);
AND FHLBB COST OF FUNDS (line)



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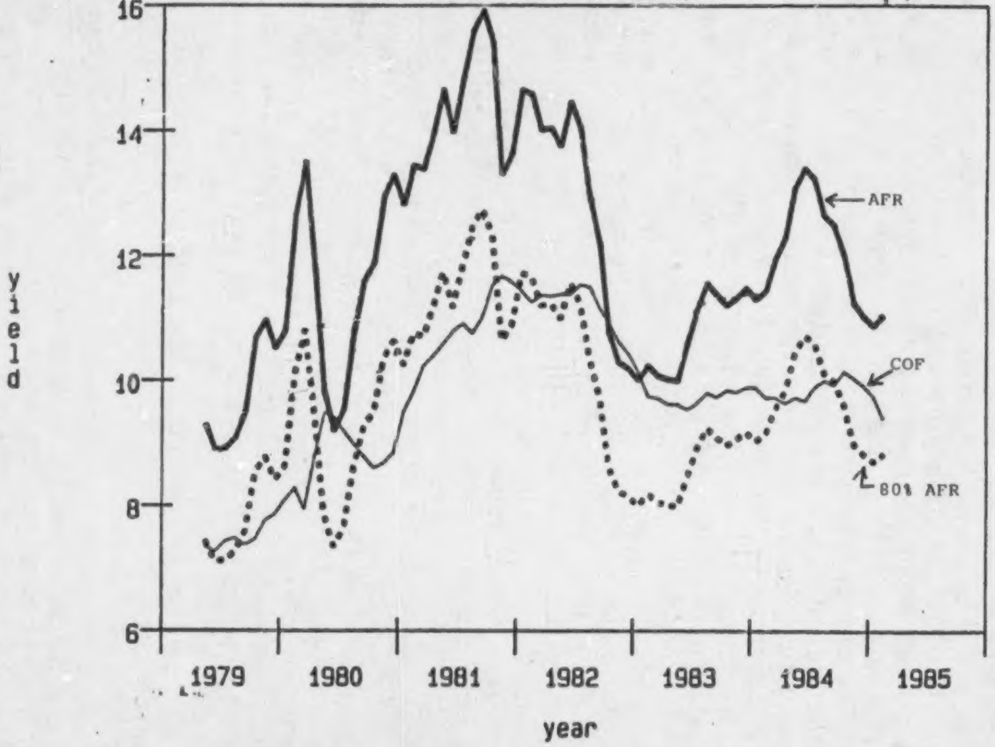
GRAPH 2

100 PERCENT (bold) AND 80 PERCENT (bold, dotted) OF THE APPLICABLE FEDERAL RATE, MID-TERM MATURITY (U.S. TREASURY 3-9 YR. MATURITY) AND FHLBB COST OF FUNDS (line)



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Mr. **Matsui**. Thank you, Mr. Simpson.

I would like to ask one question. Mr. Woodbury, you mentioned that there would be a loss of revenues when you take owner-occupied residence if you increase the rate of interest and, as a result of that, the purchaser then has and the owner then has a greater deductability, which is correct. So you lose revenues there. But, from the other side of it, it becomes ordinary income to the seller and so that individual has a greater tax consequence. So there could be an offset of revenues in that situation. Is my analysis correct?

Mr. **Woodbury**. I used the example of both the personal residence and investment properties; properties such as vacant land, which are nondepreciable. And, in those cases, if there were a match, and that was one of the Treasury's announced goals, if there were a match, there would be the same size interest deduction on the part of the buyer as there was interest income on the part of the seller. So the interest impact should be neutral.

The imputation of a lower sale price as a result of increasing the interest rate would reduce the amount of capital gain. So there would be a negative revenue impact on the Federal Government.

Now the Treasury's arguments have been in the case of income properties, depreciable properties, that the advantage of greater basis for ACRS purposes, offsets that and somehow they presume that is where the Government must suffer a loss. But, in fact, in respect to these other properties, there is no other area where the Government can gain revenue. So they, in fact, represent a loss. The other area, Mr. Matsui, that I did not elaborate, that really is not in the record that I think is really very important, is the capital loss area.

You should be aware that in the case of section 1231 property, business income property, net capital losses are ordinary business deductions, so they get taken.

But, in the case of a purchaser of vacant land who made a mistake, and he bought it for investment, or a piece of farmland that really has not been productive enough that the owner can claim it is held for purposes of income it is held for purposes of investment, and so he is in a distress situation. He decides to sell that piece of property, and he is selling it at a loss—a capital loss. A net capital loss on investment property is nondeductible. There is no deduction at all for a corporation. For an individual owner, he can deduct a maximum $3,000 a year even if it is a million dollar loss. By imputing a lower sale price and charging him a higher interest rate, you do two things: One is you increase the amount of his non-deductible capital loss of which he has no way of ever recovering the benefit of. And you do it by computing a lower sale price while trading it off and making him report more interest income.

From the buyer's standpoint, on the other side, since it is investment property, he is subject to the income limitation where he can only deduct $10,000 plus the amount of investment income he made during the year. So increasing the amount of the interest that he pays gives him no current deduction for additional interest. It is a very unfair thing and it works totally to create mismatch. And there is no provision in the bill or, frankly, in the testimony at the time of the 1984 act about the net effect on capital losses on investment properties. And there is little testimony about the interplay with the investment interest limitation. I think they are both highly critical areas that must be considered by Congress.

Mr. **Matsui**. I appreciate your clarification there. I think your last comments really hit the nail on the head. There has not been a great deal of study of the effects of other portions of the Tax Code on these provisions. In Treasury's desire to capture all income, you could end up playing with minutia in order to pick up some of these revenues.

The next thing we will do is try to match buyers and sellers in terms of the level of income, the level of tax rates. That would be the next step in order to make this coequal exactly so there is no revenue loss. And I think we may be reaching that point in our desire to bring fairness into the Tax Code.

I would like the gentlemen to respond just very briefly to the two issues that Mr. Pearlman brought up that I think we will have to discuss. One is on the issue of cash transactions, if both buyer and seller who are able to engage in cash transactions, would that be vitally important to your respective industries, or could you live with this notion of accrual being the only option available and, secondly, how important is a blend.

If you could be somewhat brief on this. I just want this for the record.

Perhaps, Mr. Williams, you could.

Mr. **Williams**. Cash is definitely preferable, and it is preferable not to have the blended rate, but a fixed rate. I would say there is no doubt but that that would represent the view of the industry.

Mr. **Simpson**. I would echo Mr. Williams' remarks.

Mr. **Matsui**. Mr. Woodbury.

Mr. **Woodbury**. I would agree, although I think that if two taxpayers, a buyer and a seller, are dealing with one another and they each happen to be using the same accounting method, I do not know why we want to fuss around with it. It would seem that if they are using the same accounting method we should honor it, and only have a presumption of some other method in cases where there was a difference between their methods.

Mr. **Williams**. Mr. Matsui.

Mr. **Matsui**. Yes.

Mr. **Williams**. On that point, one of the things he raised was the downstream effect, you will recall, of what happens later. There are many ways to deal with that aside from it being a fairly low level of incidence, and you could deal with that in the papers themselves; require that each party to the transaction on downstream deal with that. That issue should not set the tone of this debate.

Mr. **Matsui**. I should ask you about that, because he did say that it would add complexity to the process, or I do not believe he said that you people would be unhappy with the complexity. But would you be able to live if there was an effort to tighten up those downstream transactions at the same time?

Mr. **Williams**. I am not saying they are desirable, but that is one solution to that problem. I think the short answer is yes.

Mr. **Matsui**. In other words, you would prefer to keep the option of cash-cash and live with perhaps some complexity in the downside.

Mr. **Williams**. Yes.

Mr. **Matsui**. For the downstream side.

I want to take this opportunity to thank all three of you very much for your excellent testimony, and we will be in touch with you. Thank you.

The last panel I would like to call, Joseph Tapajna, with Arthur Andersen & Co.; Vincent J. Sama and Donald Feuerstein, from the New York State Mortgage Loan Enforcement and Administration Corp.; Craig T. Jones, from North Carolina; and Harold Collum from Dallas, TX, chairman of Overseas Securities, Inc.

I would like to thank all four of you gentlemen for being here today. I would like to call Mr. Joseph J. Tapajna.

STATEMENT OF JOSEPH J. TAPAJNA, TAX PARTNER, ARTHUR ANDERSEN & CO.

Mr. **Tapajna**. Thank you, Mr. Chairman.

My name is Joseph Tapajna. I am a partner in Arthur Andersen & Co. and a member of our tax accounting method specialty team.

We welcome the opportunity to testify before the Committee today on deferred payment transactions involving application of the original issue discount and imputed interest provisions.

While we have many specific clients impacted by these provisions, we do not represent these clients in testifying today. The views expressed are those of the firm, itself, and are based upon our experiences in the implementation of the rules across a broad range of industries and taxpayers.

For the interest of brevity, I would like to have my written statement, included in the record.

Mr. **Matsui**. Without objection.

Mr. **Tapajna**. I would first like to summarize four significant points and then provide a little more detail on each of those four points.

The first point is that the legislation, we believe, has proven to affect far more taxpayers than the drafters have envisioned. We believe that Congress should redirect its approach so that the focus of the original issue discount and imputed interest rules is only on the areas of perceived abuse rather than on an across-the-board basis.

Second, we believe that the testing mechanisms of the OID and imputed interest rules impose complex computational requirements on many taxpayers who will be unable to cope with these computations. Such complexity is only good for professionals, such as accounting firms.

Third, the uncertainty of application of many problem areas has deprived taxpayers of the ability to plan all the financial consequences of their transactions.

And, finally, due to the diverse nature of risks, collateral, credit worthiness, types of transactions, et cetera, any system that would impose a mandatory minimum rate of interest will necessarily be arbitrary in its application to many taxpayers.

First of all, it should be noted that all deferred payment transactions must be tested under the OID and imputed interest rules even if the potential for abuse is nonexistent or remote.

This reality has been overlooked and no doubt is a by-product of the quick enactment of the legislation and an inadequate opportunity for taxpayer input.

The OID rules have had the unintended impact of forcing tax considerations to the forefront of every negotiation. Transactions that previously had been driven solely by business and economic considerations are now seriously affected by the possible application of these rules. To limit the reach of the OID rules so that only abusive transactions are affected, Congress could adopt any of several approaches. For example, the rules could be limited to tax shelter situations, as defined in other code sections. The rules could only apply to transactions where payments extend beyond a specified time period; such as 5 years or 10 years.

The rules could apply only to transactions in excess of a stated dollar amount. In this regard, we would suggest that any dollar amount should be significantly greater than the current $250,000 limit in the rules.

Finally, a safe harbor could be permitted whereby a taxpayer could demonstrate that the purchase price of property equals its fair market value. This could be achieved through an appraisal requirement similar to the 1984 rules imposed on charitable contributions.

It is apparent to the professional community and to an increasingly large segment of the tax paying public that the OID and deferred payment transaction rules impose expensive and unnecessary tests where perceived abuses are not present. This complexity can only serve to confuse both taxpayers and make the assessment, collection, and audit process of the IRS more difficult to accomplish.

This problem is especially acute when one considers the expected unreasonable time lag between enactment of legislation and provision of adequate regulatory guidance.

There are various interpretive problems that should be addressed. Many of them have been noted in prior testimony, and include floating interest rates, contingent purchase price, contingent interest amount, assumptions of preexisting debt, priority of application of the original issue discount, section 483 and interest free loan provisions, and a determination of minimum interest rates for transactions committed to prior to January 1, 1985, but closed after December 31, 1984.

The mandatory use of any interest rate assumes, in order to avoid arbitrary application, that the benchmark upon which a mandatory interest rate is based is fair. Experience dictates that no one measure of interest reflects commercial reality for all or even most transactions. We recommend, therefore, that there should be a fixed safe harbor rate for nonabusive transactions. This safe harbor rate would be adjustable only by Congress as it saw fit from time to time.

In addition, any variable rate of interest applicable to abusive transactions should be tied to one or more commonly published market rates of interest.

We appreciate the opportunity to testify at this hearing. We urge the committee to consider our recommendations and would be pleased to answer any questions or provide any information that will aid the committee in its deliberations.

Thank you.

[The prepared statement follows:]

STATEMENT OF JOSEPH J. TAPAJNA, TAX PARTNER, ARTHUR ANDERSEN & CO.

SUMMARY

1. Every deferred payment transaction must be analyzed to determine if it runs afoul of the OID and imputed interest rules. Thus, the legislation has proven to affect far more taxpayers than the drafters envisioned. Congress should redirect its approach so that the focus of the OID and imputed interest rules is only on areas of perceived abuse rather than on an across the board basis.
2. The testing mechanisms on the OID and imputed interest rules impose complex computational requirements. Many taxpayers will be unable to make such calculations without outside assistance.
3. While all deferred payment transactions must be tested under the OID rules, the currrent law does not explain its application to many common business transactions. The uncertainty of application deprives taxpayers of the ability to plan the financial consequences of their transactions.
4. Due to the diverse nature of risks, collateral, creditworthiness and types of transactions, any system that would impose mandatory minimum rates of interest will necessarily have an arbitrary effect on the great majority of taxpayers. Safe harbor minimum interest rates should be provided by statute for nonabusive transactions as defined by Congress. These rates should be adjusted only from time to time as Congress may see fit and should not fluctuate periodically with federal interest rates.

INTRODUCTION

My name is Joseph J. Tapajna. I am a Partner in Arthur Andersen & Co. and a member of our Tax Accounting Methods Specialty Team. We welcome the opportunity to testify before this Committee today on deferred payment transactions involving application of the original issue discount ("OID") and imputed interest provisions. While we have many specific clients affected by these provisions, we do not represent these clients in testifying today. The views expressed are those of the firm itself and are focused upon problems encountered in the implementation of the rules across a broad range of industries and taxpayers.

SUMMARY OF GENERAL ISSUES AND RECOMMENDATIONS

We believe that there are three fundamental problems with the OID and imputed interest provisions. These problems are:

Unintended application to a broad range of arm's-length commercial transactions, complexity in application, and imposition of an arbitrary interest rate that does not reflect economic reality.

These problems were addressed by Richard A. Helfand, a Partner in Arthur Andersen & Co. and Director of our Tax Accounting Methods Specialty Team in our firm's February 24, 1984 testimony before the Committee on Ways and Means Subcommittee on Oversight.

We recommend that the OID and imputed interest rules apply only to transactions entered into in connection with plans or arrangements designed to evade or avoid income tax. Standard commercial transactions should be exempted from these rules in their entirety or through an expanded de minimis rule. Taxpayers engaging in normal commercial transactions should be entitled to use a fixed statutory safe-harbor rate of interest and their usual method of accounting for interest income and expense. We further recommend that the effective date of the OID rules be postponed until the law is clarified by further legislation.

BACKGROUND OF OID AND IMPUTED INTEREST RULES

In enacting the deferred payment transaction legislation, Congress addressed four perceived taxpayer abuses. First, Congress was concerned with the mismatching of interest income and expense between sellers and buyers of property. Second, Congress believed that interest might be allocable among the periods during which a debt was outstanding on a noneconomic basis, such as the "Rule of '78's" or straight line method.

Third, Congress sought to curtail techniques that permitted the depreciable basis of property purchased for debt to exceed the fair market value of the property. Finally, Congress wanted to eliminate the opportunity for sellers of nonpublicly traded property to convert interest income, taxed at ordinary rates, to preferentially taxed capital gain.

Congress countered these abuses by applying two general concepts to deferred payment transactions. The first is the requirement of symmetrical accrual accounting for interest income and expense for buyers and sellers in deferred payment transactions coupled with a requirement that the interest segment of the debt be allocated on an economic basis.

Second, Congress provided that a minimum rate of interest based on the applicable federal rate must be stated in deferred payment transactions. Soon after enactment, affected taxpayers realized that the applicable federal rate was a flawed concept that did not represent economic realities. Congress enacted a temporary form of rate relief in H.R. 5361 (the "October Stop-Gap Rules") in the fall of 1984. More recently, Treasury made a further attempt to alleviate the problem caused by the applicable federal rate. Under the apparent authority of Section 1275, Treasury issued temporary regulations providing for alternative applicable federal rates to be determined every month instead of semiannually.

SWEEPING COVERAGE OF THE RULES

All deferred payment transactions must be tested under the OID and imputed interest rules, even if the potential for abuse is nonexistent or remote. Since the test is required in virtually every case, the reach of the rules is overbroad. This reality has been overlooked, and no doubt is a by-product of the quick enactment of the legislation and inadequate opportunity for taxpayer input.

The OID rules have had the unintended result of forcing tax considerations to the forefront of every negotiation. Transactions that previously had been driven solely by business and economic considerations are now seriously affected by the possible application of the OID rules. The broad coverage of the rules, along with their failure to address many practical business situations, ensures that there will be many areas of uncertain application.

We do not believe Congress intended to force taxpayers to apply these complex rules to all deferred payment transactions. We do believe, as Treasury pointed out during mark-up on the original 1984 rules, that some constraints on the timing and amount of interest deductions are needed so that abusive transactions will be curtailed. To limit the reach of the OID rules so that only abusive transactions are affected, Congress could adopt any of several approaches. For example:

The rules could be limited to all tax shelters, as defined in Section 6661(b)(2)(C).

The rules could apply to a transaction where payments extend beyond a specified time period (such as five years).

The rules could apply only to transactions in excess of a stated dollar amount. The amount should be substantially greater than the $250,000 limit of the original rules.

A safe harbor could be created permitting the taxpayer to demonstrate that the purchase price equals the fair market value. This could be achieved through an appraisal requirement similar to the 1984 rules imposed on charitable contributions.

COMPLEXITY OF THE RULES

The problems associated with the broad reach of these rules to all deferred payment transactions are exacerbated by the extraordinary complexity of the rules. It is apparent to the professional community and to an increasingly large segment of the taxpaying public that the OID and deferred payment transaction rules impose expensive and unnecessary tests where perceived abuses are not present. This complexity can only serve to confuse taxpayers and, unless they obtain expert assistance, deprive them of the opportunity to accurately quantify the tax cost or benefit of many transactions into which they enter. Such complexity will make many transactions more difficult for the Service to audit and will require significant additional training for field auditors. This problem is especially acute when one considers the expected unreasonable time lag in providing adequate regulatory guidance. Such complexity can only serve to undermine taxpayer confidence in the integrity of our self-assessment system.

Recently, David Garlock, Acting Associate Tax Legislative Counsel, published an article entitled "Mathematical Concepts in the Time Value of Money." The article outlines many of the calculations and complex algebraic formulae necessary to apply the OID rules. The article vividly illustrates that these computations are only feasible if the taxpayer, or its advisors, have access to sophisticated electronic equipment. The complexity is so great that an alternation in the order in which the calculations are performed can lead to differences in result—an obvious trap for unsophisticated or unwary taxpayers.

In addition to the mathematical complexity of the OID rules, a myriad of interpretative complexities remain unresolved. Many of these could be clarified through regulations. However, considering the heavy workload at Treasury, as well as the fundamental nature of many of these problems, Congress should provide specific legislative guidance to resolve these interpretative problems. Some of the more troublesome problem areas include:

Floating interest rates; contingent purchase price; contingent interest; points and service fees; assumptions of preexisting debt; priority of application of the OID rules, Section 483 and the interest-free loan provisions, and determination of minimum interest rates for transactions committed to prior to January 1, 1985 but closed after December 31, 1984.

The problems in these areas are well documented, and we understand that Treasury is considering various regulatory remedies. The lack of guidance at this time has the undesirable effect of preventing business from being able to ascertain the tax consequences of completed transactions.

To date, it appears that taxpayers and practitioners have been anticipating congressional action to repeal or simplify these provisions. Further attempts to apply patchwork solutions to a fatally flawed framework are doomed to failure. If Congress chooses to maintain the status quo, taxpayers will continue to importune this committee for changes. Thus, we recommend that Congress act immediately to defer the effective date of the OID and deferred-payment transaction legislation until regulations are published. Moreover, additional congressional action is needed to limit and modify the present rules and provide guidance on the interpretive problems noted above.

ARBITRARY IMPUTED INTEREST RATES

A serious concern that was addressed by Congress in the October Stop-Gap Rules and by the Treasury Department in its temporary regulations, is the failure of the imputed interest provisions to fairly deal with the rich diversity of legitimate business transactions and taxpayer situations. The mandatory use of any interest rate assumes, in order to avoid arbitrary application, that the benchmark upon which the mandatory rate is based is fair. Experience dictates that there is no one measure of interest that reflects commercial realty for all or even most transactions. The effort in the October Stop-Gap Rules and the temporary regulations has only resulted in further complexities without solving the underlying fairness problem. Now a taxpayer can be faced with a choice between four different imputed interest rates for the same transaction.

We acknowledge that any fixed interest rate is by nature arbitary. Nonetheless, we believe there should be a fixed "low hurdle" safe harbor rate for nonabusive transactions. This safe harbor rate would be adjustable only by Congress. In addition, any variable rate of interest applicable to abusive transactions should be tied to one or more commonly published market rates of interest.

SUMMARY AND RECOMMENDATIONS

In summary, we believe that the current legislative system covering deferred payment transactions is overly broad, and too complex for the great majority of deferred payment transactions negotiated on an arm's-length basis. The rules are also arbitrary in their selection of imputed interest rates.

Accordingly, we recommend that the deferred payment transaction concepts—symmetrical accrual accounting and minimum rates of interest—be targeted to the areas of perceived abuses, such as in plans or arrangements designed to avoid or evade tax. Congress should provide specific statutory guidance in problematic interpretive areas and consider deferring the effective date until such guidance is available.

As an alternative, safe harbors should be created so the rules will only apply if certain characteristics, such as nonrecourse debt or significantly deferred payments of interest are present. We also recommend enactment of a significantly expanded de minimis rule designed to exempt most commercial transactions. The current $250,000 rule encompasses too many transactions, so the dollar limit should be enlarged substantially.

We further recommend that a fixed statutory imputed interest rate be enacted for transactions in nonabusive areas, regardless of type or size. Taxpayers should be entitled to use the lesser of this fixed statutory safe harbor rate or the statutory or regulatory minimum interest rate in structuring their transactions.

We also suggest that recent experience has proven that the statutory and regulatory federal rates, however often they are issued, are based on a faulty benchmark. Accordingly, we recommend that the imputed interest rates be tied to one or more measures of interest that more closely approximate the market and that the 110% and 120% features of the current rules be eliminated.

We appreciate the opportunity to testify at this hearing. We urge the Committee to consider our recommendations in its deliberations on these important provisions. We will be pleased to answer any questions that members of the Committee or its staff may have about our comments and recommendations, or to furnish any additional information that may aid in your consideration of these proposals.

Mr. Matsui. Thank you.

I would like to call at this time Mr. Sama.

STATEMENT OF VINCENT J. SAMA, EXECUTIVE VICE PRESIDENT, NEW YORK STATE MORTGAGE LOAN ENFORCEMENT AND ADMINISTRATION CORP., ACCOMPANIED BY RONALD A. FEUERTSTEIN, COUNSEL

Mr. Sama. Thank you very much, Mr. Chairman.

I am Vincent J. Sama, executive vice president of the New York State Mortgage Loan Enforcement and Administration Corp., more commonly referred to as MLC.

I appreciate your courtesy in considering the following statement on behalf of MLC. My comments are directed specifically to the application of the term modification to transactions undertaken by MLC.

With me is Ronald A. Feuertstein, of Brownstein Zeidman & Schomer of Washington, DC.

MLC is a subsidiary of the New York State Urban Development Corp., referred to as UDC. MLC is responsible for $1.2 billion of subsidized low-income housing loans originated by UDC. Most of this housing was built pursuant to the HUD assisted, but uninsured section 236 program, and carries low rates of interest. Many of our uninsured project mortgages have experienced financial problems, and we currently have debt service arrears in excess of $140 million.

To make needed repairs, to maintain the facilities and to avoid foreclosure, these projects need to attract investors who are willing to contribute cash and assume ownership and operation of the properties.

The infusion of capital combined with the deferral of debt service enables the new owners to make the capital contribution and improvements required to stabilize the operations of the properties and to attract tenants so that the cash-flow from the property will become sufficient to meet its operation costs, including debt service, normal operating expenses and repairs.

Unfortunately, the adoption of the imputed interest and original issue discount [OID] rules has had a significant adverse impact on the ability of these troubled low-income properties to attract investors having the cash to make improvements. Failure to raise needed capital would result in further deterioration of this valuable housing stock which cannot be replaced due in part to elimination of Federal programs for low-income tenants. Even if new production programs did exist, however, the cost of duplicating these projects has increased threefold.

It makes no sense not to preserve this valuable housing stock.

The October 11, 1984, legislation exempted from the OID rules assumptions of loans if the terms and conditions of the debt obligation were not modified in connection with the transaction.

Under the usual resyndication structure utilized with a troubled project, investors assume existing debt on property. To make subsidized housing projects that have debt service payments in arrears attractive to investors, the practice in the industry has been to execute workout agreements under which a lender agrees to forbear on foreclosure, to defer debt service arrearages and/or to permit future debt service shortfalls in conjunction with the assumption of debt. It is critical that these workout agreements are not treated as modifications of the assumed debt obligations since such treatment would subject the debt obligations to the new OID rules.

Subjecting troubled projects to the OID rules will not only inhibit investment in these projects, but will also create additional cash flow problems.

In the absence of OID application, the below market interest rate would carry over to the purchaser, resulting in payments to the mortgagee that are significantly less than they would be had the entire purchase price been newly financed.

The reduced payments benefit the project in that more funds are available for project improvements and expenses of the project. It must be recognized that properties on which workouts would be implemented are subsidized low-income housing projects.

Congress has over the years repeatedly recognized the special status of low-income rental projects and provided special tax treatment for investors to encourage them to invest in low-income housing. This offsets the market limitations on rents and amount of cash-flow profit the subsidized housing project can earn.

To maintain the continued ability of certain projects to house the poor, rules regarding modifications of assumed loans should favor low-income housing. Housing projects currently in arrears in debt service cannot become viable self-supporting projects without the infusion of additional capital. The additional equity required for capital improvements is found by selling the property to investors who are willing to risk their capital. In return, they demand, and rightly so, some benefits as consideration. Since there is no cash-flow and no assurance of long-term appreciation, these benefits have historically taken the form of tax advantages.

Were the OID rules to apply to mortgages assumed in such resyndications, depreciation deductions would be reduced. By reducing depreciation, one of the major tax advantages associated with real estate, few projects will be purchased by private sector investors. The likely alternative is foreclosure.

Since MLC's ability to sell a property after foreclosure is also significantly inhibited, it serves no one's needs.

Under Senate 217, introduced by Senator Melcher, the OID rules would not apply to any debt instrument by reason of the assumption of such instrument.

To ensure the continued influx of private sector funds into low-income subsidized housing, we recommend that the committee adopt a similar provision. In the alternative, we recommend that all assumptions of loans relating to low income housing be exempted from the OID rules.

If a total exemption of assumptions is not acceptable, we recommend that the definition of the term "modification" exclude from its coverage all workout agreements, one, which were entered into by a governmental entity holding, insuring, or subsidizing the loan and, two, which arise in the resyndication of low-income subsidized housing projects that carry below-market interest rates and have debt service in arrears.

I wish to comment on one further matter. Senator Durenberger and Congressman Matsui have introduced bills, Senate 729 and House 2069, respectively, under which no interest will be imputed on the sale or exchange of property if one, the parties state an interest rate equal to the lesser of 9 percent or 80 percent of the applicable Federal rate, and, two, the borrowed amount does not exceed $4 million. We recommend that the committee adopt provisions similar to those contained in these rules.

I will be happy to answer questions and supply the committee with any additional information.

Thank you.

[The prepared statement follows:]

STATEMENT OF VINCENT J. SAMA, EXECUTIVE VICE PRESIDENT, NEW YORK STATE MORTGAGE LOAN ENFORCEMENT AND ADMINISTRATION CORP.

SUMMARY

The New York State Loan Enforcement and Administration Corporation ("MLC") has in its portfolio many uninsured HUD assisted Section 236 Program mortgages on projects occupied by low and moderate income tenants that have experienced financial problems and which currently have debt service arrears in excess of $140 million. To make needed repairs to maintain the facilities and to avoid foreclosure, these projects need to attract investors who are willing to contribute cash and assume ownership and operation of the property. The adoption of the imputed interest and OID rules has significantly inhibited, and in many cases stopped, investment in such properties, leaving foreclosure as the alternative. Foreclosure serves no one's needs since MLC's ability to sell the property after foreclosure is also significantly inhibited.

Under the normal resyndication structure, investors assume or take subject to existing debt and enter into "work-out" agreements with creditors. Under "work-out" agreements, creditors agree to forebear on foreclosure, to defer debt service arrearages and/or to permit future debt service shortfalls. The October 11, 1984, legislation exempted assumptions of loans from the OID rules if their terms were not modified in the transaction. It is critical that these "work-out" agreements are not treated as modifications of the assumed debt obligations.

Most "work-out" agreements are implemented with respect to low-income subsidized housing. Both Congress and the Treasury have, over the years, provided special tax advantages for low-income housing to offset the market limitations on rents and amounts of cash flow profit a subsidized housing project can earn. To maintain the continued ability of certain projects to house the poor, rules regarding modification of assumed loans should favor low-income housing to ensure the continued influx of private-sector funds into low-income subsidized housing. We recommend that the Committee approve legislation incorporating a provision similar to that in Senator Melcher's bill (S. 217) which would exempt all assumptions of loans from the OID rules. In the alternative, we recommend that all assumptions of loans relating to low-income housing be exempted from the OID rules. If a total exemption of assumptions is not acceptable, we recommend that the definition of the term "modification" exclude from its coverage all "work-out" agreements which are entered into by a governmental entity holding, insuring or subsidizing the loan and which arise in the purchase of low-income subsidized housing projects that carry below-market interest rates and have debt service in arrears.

Good day. I am Vincent J. Sama, the executive vice president of the New York State Mortgage Loan Enforcement and Administration Corporation (MLC). I appreciate your courtesy in considering the following statement on behalf of MLC. My comments are directed specifically to the application of the term "modification" to transactions undertaken by MLC. With me is Ronald Feuerstein, of Brownstein Zeidman and Schomer of Washington, D.C.

MLC is a subsidiary of the New York State Urban Development Corporation (UDC). MLC is responsible for $1.2 billion of subsidized, low-income housing loans originated by UDC. Most of this housing was built pursuant to the HUD assisted but uninsured section 236 program and carries low rates of interest. Many of our uninsured project mortgages have experienced financial problems and we currently have debt service arrears in excess of $140 million.

To make needed repairs to maintain the facilities and to avoid foreclosure, these projects need to attract investors who are willing to contribute cash and assume ownership and operation of the property. The infusion of capital, combined with the deferral of debt service, enables the new owners to make the capital contribution and improvements required to stabilize the operations of the properties and to attract tenants so that the cash flow from the property will become sufficient to meet its operation costs, including debt service, normal operating expenses and repairs. Unfortunately, the adoption of the imputed interest and Original Issue Discount (OID) rules has had a significant adverse impact on the ability of these troubled low-income properties to attract investors having the cash to make improvements.

Failure to raise needed capital will result in further deterioration of this valuable housing stock which cannot be replaced due in part to the elimination of Federal programs for low income tenants. Even if new production programs did exist, however, the cost of duplicating these projects has increased three fold. It makes no sense not to preserve this valuable housing stock.

The October 11, 1984, legislation exempted from the OID rules assumptions of loans if the terms and conditions of the debt obligation were not "modified" in connection with the transaction.

Under the usual resyndication structure utilized with a troubled project, investors assume existing debt on property. To make subsidized housing projects that have debt service payments in arrears attractive to investors, the practice in the industry has been to execute "work-out" agreements under which a lender agrees to forebear on foreclosure, to defer debt service arrearages and/or to permit future debt service shortfalls in conjunction with the assumption of the debt. It is critical that these "work-out" agreements are not treated as "modifications" of the assumed debt obligations since such treatment would subject the debt obligations to the new OID rules.

Subjecting troubled projects to the OID rules will not only inhibit investment in these projects, but will also create additional cash flow problems. In the absence of OID application, the below-market interest rate would carry over to the purchaser, resulting in payments to the mortgagee that are significantly less than they would be had the entire purchase price been newly financed. The reduced payments benefit the project in that more funds are available for project improvements and other expenses of the project.

It must be recognized that properties on which "work-outs" would be implemented are subsidized, low-income housing projects. Congress has, over the years, repeatedly recognized the special status of low-income rental projects and provided special tax treatment for investors to encourage them to invest in low-income housing. This offsets the market limitations on rents and amount of cash flow profit a subsidized housing project can earn.

To maintain the continued ability of certain projects to house the poor, rules regarding modifications of assumed loans should favor low-income housing. Housing projects currently in arrears in debt service cannot become viable, self-supporting projects without the infusion of additional capital. The additional equity required for capital improvements is found by selling the property to investors who are willing to risk their capital. In return, they demand, and rightly so, some benefits as consideration. Since there is no cash flow and no assurance of long-term appreciation, these benefits have historically taken the form of tax advantages. Were the OID rules to apply to mortgages assumed in such resyndications, depreciation reductions would be reduced. By reducing depreciation, one of the major tax advantages associated with owning real estate, few projects will be purchased by private-sector investors. The likely alternative is foreclosure. Since MLC's ability to sell the property after foreclosure is also significantly inhibited, it serves no one's needs.

Under S. 217, introduced by Senator Melcher, the OID rules would not apply to any debt instruments by reason of the assumption of such instrument. To ensure the continued influx of private-sector funds into low-income subsidized housing, we recommend that the committee adopt a similar provision. In the alternative, we recommend that all assumptions of loans relating to low-income housing be exempted from the OID rules. If a total exemption of assumptions is not acceptable, we recommend that the definition of the term "modification" exclude from its coverage all "work-out" agreements (1) which are entered into by a governmental entity holding, insuring or subsidizing the loan and (2) which arise in the resyndication of low-income subsidized housing projects that carry below-market interest rates and have debt service in arrears.

I wish to comment on one further matter. Senator Durenberger and Congressman Matsui have introduced bills (S. 729 and H.R. 2069, respectively) under which no interest will be imputed on the sale or exchange of property if (1) the parties state an interest rate equal to the lesser of 9% or 80% of the applicable Federal rate and (2) the borrowed amount does not exceed $4,000,000. We recommend that the committee adopt provisions similar to those contained in these rules.

I will be happy to answer questions and to supply any additional information the committee may request.

Thank you.

Mr. **Matsui**. Mr. Jones.

STATEMENT OF CRAIG T. JONES, REAL ESTATE BROKER, WINSTON-SALEM, NC

Mr. **Jones**. Thank you.

My name is Craig Jones and I am a real estate broker in North Carolina and South Carolina, a small-time real estate investor, primarily concentrating in low- to moderate-income rental properties in North Carolina. I am currently a third-year law student also.

I have two proposals here, and I am going to try to avoid repeating anything that has already been said. I am just going to hit upon some of the highlights. Basically, these are written in resolution form.

One is essentially repeal of section 483, or really repeal with a kick. And the other is basically preserving the section but modifying the index and safe harbor rates and so forth.

The first proposal, calling for repeal, is based on the premise that the imputed interest rule, as currently set forth, is confusing, burdensome and a trap for the unwary.

I think it is evident from the testimony that has already been given that the rule is confusing; it is complex and various interests have testified that it is burdensome.

I would like to focus on one particular aspect of the real estate market that I do not feel has been addressed so far. I do not own any shopping centers yet, but I own low-income single-family housing. And my concern is with low-income tenants and small mom and pop investors who, at least in the area where I work, probably own a majority of the rental housing which is available.

In my market area, it is still possible for a guy with a high school diploma and a relatively decent job to find a house in a non-crime-infested neighborhood for $20,000 to $35,000.

By and large, these transactions are financed through investor/owners. Lending institutions, in my opinion, still practice redlining in our community and in a lot of communities. It is easy to get away with it. All you have to do is say your collateral is not secure because of depreciating property values, even though depreciation is caused by the fact that no institutions are making loans in those areas. I have had one banker tell me that by eliminating these low-interest loans, the imputed interest rule is forcing borrowers who are marginal credit risk into the commercial lending market and it is, consequently, either forcing interest rates to go up or forcing lenders to just redline certain areas of concentrated low-income housing.

One of the concerns which I have with the way the bill is currently phrased is that there is an exclusion for the sale of a principal residence. But this is the sale of a principal residence in the hands of a seller. In many communities in this country, rental property is converted to primary residences because tenants will buy from the owner on either a land contract or purchase money mortgage.

I, personally, am doing this right now with a fellow who has been paying rent down the drain for some 13 years, who cannot come up with the cash necessary for a down payment on a conventional loan, but I was able to refinance the property and then get him to assume my loan.

As far as my statement that the imputed interest rule serves as a trap for the unwary, my objection here, particularly with your mom and pop type operations, is that the rule is completely unknown until the IRS steps in and audits somebody. And what you have then is a closed transaction where your payment schedule is already set and the effect of imputing interest is that the IRS reallocates certain portions of each payment as being either interest or principal. What happens is the seller is penalized because all this capital gain is now converted to ordinary income and the buyer actually receives a windfall. And it is possible in this type of situation where you have someone like me who is relatively familiar with the tax law to take advantage of this inequity. I can go to an old lady and I can buy a house at 8 percent interest, knowing that a year from now the Service is going to come in and impute a higher rate and I am going to get a bigger deduction without paying a higher price for the property.

I have never done it, but it is possible.

OK. Another comment is that repeal of the rule would not detrimentally affect total revenue collections in the vast majority of transactions governed by the rule. I think in the aggregate there will probably not be a net decrease in revenue collections if the rule is repealed. Just looking at individual transactions, everytime you have a seller who is able to characterize what would otherwise be imputed interest as principal, there is also a buyer who is going to receive a proportionately greater reduction in his interest deduction. And there really has to be a substantial spread in the tax brackets, the buyer and seller, for the Treasury to lose money on the transaction.

With respect to the seller, the tax bracket is going to go from 20 percent up to 50 percent. So, in terms of percentage points on your marginal rate, that is a 30-point differential, but your buyer is going to have an interest deduction which is going to be reduced so that the same amount of interest that would have otherwise been imputed, he is going to have a 50-point increase in his tax rate. So you have to have at least a 20-point spread in tax brackets in order for the Treasury to actually come out a loser, notwithstanding any effect on basis or investment tax credit, or anything like that. But I think because of the time factor—that is, the deferred nature of those basis adjustments—that there is probably not going to be substantial loss to the Treasury.

So, basically, what I am suggesting is that there be created a statutory presumption that any interest rate which is agreed upon is reasonable, it is a result of arms length bargaining, and it does reflect market conditions in the community where the transaction is entered into. And then, in case the IRS does find a particularly flagrant abuse, we would have a subjective test whereby the IRS could step in and impute interest if it was one of these rare situations where tax considerations did motivate the sale and where there actually was potential for tax avoidance.

Also, I would suggest that if interest is imputed in such a situation that it be imputed at the applicable Federal rate, and not using some harsh penalty.

Furthermore, as far as exceptions to the rule go, the only existing exception I would change would concern the current exception for sales of $3,000 or less. Personally, I think there should be a floor much higher than that, but Congress has established that its policy is that $3,000 is apparently not enough to mess with, so I am not going to argue with that reasoning. But I feel the significant thing is not the sales price of the property, but the amount of the debt—that is, amount of the purchase money mortgage or installment obligation.

For example, when someone sells a $50,000 house and only takes back a $2,000 second mortgage, I just do not think that should be covered by the imputed interest rule.

My other proposal is pertinent only if Congress has the same lack of foresight that it did in passing 483 in the first place, in which case I would simply change the section so that, instead of establishing a safe harbor rate at 110 percent of the applicable Federal rate, it would be set at 80 percent. This will reflect the economic reality that the reason people obtain owner financing, in the first place, is because they can get it below market rates. Then, if necessary, I would propose that we impute interest at 100 percent rather than 120 percent of the applicable Federal rate. And, furthermore, if we were going to have or keep section 483 in the code, I would also insert a section which was in the code prior to 1984, which is no longer in the code, and that is where a seller would receive only ordinary income from a sale, interest would not be imputed in that situation.

I think currently short-term capital gains, which are taxed at ordinary income rates, are excluded because there is a 6-month requirement in the new section. But if someone such as a homebuilder sells property that is characterized as inventory, the way the section currently reads, interest will be imputed, even though there is no potential for converting capital gain to ordinary income.

I think I have talked too long.

[An attachment to the prepared statement follows:]

Proposal No. 1

Whereas, the imputed interest rule set forth under section 483 of the Internal Revenue Code is confusing, burdensome, and a trap for the unwary in that its application tends to penalize sellers and provide a windfall for buyers; and

Whereas, repeal of the rule would not detrimentally affect total revenue collections in the vast majority of transactions governed by the rule, because for every seller who was able to characterize what would otherwise be imputed interest (ordinary income) as principal (capital gain), there is a buyer who receives a proportionately greater reduction in his interest deduction; and

Whereas, the only instances in which charging below-market interest rates would detrimentally affect revenue collections involve those transactions where the seller is in a substantially higher tax bracket than the buyer;[1]

Therefore, section 483 of the Internal Revenue Code is hereby amended to read as follows:

SECTION 483. INTEREST ON CERTAIN DEFERRED PAYMENTS

(a) General rule—Except as provided in subsection (b), in the case of an contract for the sale or exchange of any property under which some or all of the payments are due more than 1 year after the date of such sale or exchange, there is a presumption that whatever rate of interest is agreed upon and stated in the contract was the product of arms-length bargaining between the parties and current market conditions.

(b) Tax avoidance purpose—If, taking into consideration all of the circumstances of a sale or exchange of the nature described in subsection (a), it appears that a principal motive of any party to the sale or exchange was, with respect to the rate of interest agreed upon and stated in the contract, to avoid payment of federal income taxes, then there shall be treated as interest that portion of the total unstated interest (as defined in subsection (d)) under such contract which, as determined in a manner consistent with the method of computing interest under section 1272(a), is properly allocable to such payment.

(c) Total unstated interest—For purposes of this section, the term "total unstated interest" means, with respect to a contract for the sale or exchange of property, an amount equal to the excess of—

(1) the sum of the payments to which this section applies which are due under the contract, over

(2) the sum of the present values of such payments and the present values of any interest payments due under the contract.

For purposes of the preceding sentence, the present value of a payment shall be determined under the rules of section 1274(b) (2) using a discount rate equal to the applicable federal rate determined under section 1274(d).

(d) Exceptions and limitations—

(1) Coordination with Original Issue Discount Rules—This section shall not apply to any debt instrument to which section 1272 applies.

(2) Purchase Money Mortgages and Installment Debts of $3,000 or Less—This section shall not apply to any payment on account of the sale or exchange of property if it can be determined at the time of such sale or exchange that the amount of the deferred principal payments, notwithstanding any interest thay might be imputed under this section, cannot exceed $3,000.

(3) Carrying Charges—In the case of the purchaser, the tax treatment of amounts paid on account of the sale or exchange of property shall be made without regard to this section if any such amounts are treated under section 163(b) as if they included interest.

(4) Certain Sales of Patents—In case of any transfer described in section 1235(a) (relating to sale or exchange of patents), this section shall not apply to any amount contingent on the productivity, use, or disposition of the property transferred.

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[1] If the imputed interest rule were repealed and interest rates were freely manipulated in order for sellers to avoid ordinary income tax, the result would be that the Treasury would lose tax revenue from the seller in an amount equaling up to 30% of the unstated interest (30% being the difference between the maximum ordinary marginal rate and the maximum capital gains rate). This tax reduction with respect to the seller would be offset by a tax increase of up to 50% of the unstated interest with respect to the buyer, in the form of a lower ordinary loss deduction for interest payments. Therefore, if the marginal tax rates of the buyer and seller are less than 20 percentage points apart (nothwithstanding the impact of any increased basis or ITC for the buyer), the Treasury comes out ahead. If the spread between tax brackets is greater than 20 points (again notwithstanding basis considerations), then the Treasury loses and there is a reduction in the total tax revenue generated by the transaction.

PROPOSAL NO. 2

Whereas, the safe harbor interest rate established under section 483 of the Internal Revenue Code is unreasonably high and does not reflect the economic reality that purchasers agree to seller financing in order to pay below-market interest rates, and compelling private parties to observe this rate will, over the longrun, have substantial adverse impact upon real estate markets, financial institutions, and low-income borrowers; and

Whereas, application of the imputed interest formula imposes an unreasonably harsh penalty on unwary sellers who fail to charge what is already an excessive safe harbor rate; and

Whereas, tax equity considerations demand that buyers and sellers of all types of property be treated equally for purposes of section 483;

Therefore, section 483 of the Internal Revenue Code is hereby amended as follows:

(1) In the last sentence of subsection (b), the phrase "120 percent of" is deleted, with the effect being that interest will be imputed at just 100% of the applicable federal rate.

(2) In subsection (c)(1)(B), the phrase "110 percent of the applicable federal rate" is changed to read "80% of the applicable federal rate."

(3) In subsection (d)(2), the caption "Sales Prices of $3,000 or Less" is changed to read "Purchase Money Mortgages and Installment Debts of $3,000 or Less." In the following sentence, the phrase "sales price cannot exceed $3,000" is changed to read "total amount of the deferred principal payments, notwithstanding any interest imputed under this section, cannot exceed $3,000."

(4) The following sentence, to be known as subsection (d)(5), is inserted after subsection (d)(4): "Treatment of Seller—In the case of the seller, the tax treatment of any amounts received on account of the sale or exchange of property shall be made without regard to this section if all of the gain, if any, on such sale would be considered as ordinary income."

(5) Subsections (e) and (f) are deleted.

Mr. MATSUI. That is OK. Thank you very much.

STATEMENT OF W. HAROLD COLLUM, CHAIRMAN, OVERSEAS SECURITIES CO., INC.

Mr. COLLUM. Mr. Chairman, members of the committee.

My name is Harold Collum. I am a real estate investor personally and chairman of Overseas Securities, which is an American Stock Exchange-listed company.

The government that governs least, governs best.

Under the current law, the minimum interest rate that must be used to avoid imputed interest by the IRS is calculated using a 6-month average. In today's marketplace, rates change so quickly that this method is already outmoded.

This annual rate is now 14.75 percent for mid-term debt of 3 to 9 years. This is much higher than institutional rates. By comparison, the mid-term market yield on Government obligations on April 22, 1985 was 10.75 percent, approximately. This four point spread is unreasonable and extreme. Use of the bi-annual Federal rate is inequitable and out of line with the marketplace.

The rate used needs to be more in line with current market conditions. A means to accomplish this would be to use the Federal discount rate which is currently at 8 percent.

If Congress fears the Federal discount rate could float too low, a minimum floor could be instituted, say 9 percent. Or a flat percentage could be added to the Fed rate.

From the individual's viewpoint, the 9 percent return on real estate debt is reasonable. If he had received cash instead of the note, today he could invest it in safe, conservative mid-term investments, yielding from 8½ percent to 10¾ percent.

His note should be considered safe, because the collateral is property which he once owned and liked. And, if he had to take it back, he would have less invested than he sold it for because he had also received a down payment.

Forcing an owner to charge an unrealistically high interest rate will definitely slow the sale of real estate. When a property is not sold, there is no taxable revenue to the Federal Government.

The more attractive these sales, the more volume there will be and, therefore, more revenue for the Government, rather than less.

I understand some guidelines are necessary to avoid unrealistically low interest rates intended solely to change ordinary income into capital gains.

But, I ask you to consider making these controls as reasonable as possible to avoid interfering with the sale of property and, ultimately, the slowing of tax revenues received by the Federal Government.

CD rates per the Wall Street Journal for 6 months is currently at the rate of 8.25 percent; for 1-year CD's, it is 8.75 percent. A Fed discount rate plus 1 percent currently would equal 9 percent which, in my opinion, would be a reasonable rate.

Government should try to increase trade and not restrain it.

Business and economics work best when free of controls, or as free as possible.

Therefore, I ask you to seriously consider and then adopt a rate tied to a current market rate. A rate based on a lagging indicator is usually too high or too low. Either way, neither the Government nor the real estate industry is well served.

I believe it was the Honorable Sam Gibbons this morning who was asking the Assistant Treasury Secretary what the current rate was regarding imputed interest which is what we are all here discussing today. And they hustled around and it seemed like between all of their assistants and everything, they still could not find out that rate. If it is that much of a problem for the Treasury, it is too much of a problem for the average individual investor.

I would propose a simple rate where you can take the Wall Street Journal, on the front page, table of contents, look up money rates, which is on page 49 today. On page 49 it has the Federal discount rate which is 8 percent. So you do not have to wonder and call the Treasury Department to try to find out what the rate is currently. You look in your Wall Street Journal today and if you have a rate tied to the Federal discount rate, then you know what that rate is.

I would like to also have you consider excluding land from the threshold because land is not a depreciable asset.

The Treasury was concerned about more of a higher basis of property for depreciation purposes, so this would not apply to land. And, for one example, I have a piece of land that I am currently attempting to sell through a major broker in Dallas, the Henry S. Miller Co., who is well-established, the oldest firm in Dallas and one of the third largest in the United States. It has been appraised slightly in excess of $9 million and we are asking a $9 million figure. I have had the property for a number of years, and have a very low basis in it. A loan of $4 million is on the property today which was made at a time when rates were much higher. I am paying prime plus 2 but with a floor of 14 percent. I have to offer the property, I believe, on a rate that is reasonable on my difference between what I will receive for the property and my mortgage that I have on the property. And, if I am not able to sell the property, which I think will be much tougher, if not impossible to sell at the rate that I would currently have to charge under this act, because it is certainly above any threshold amount that is currently being discussed. And, if I do not sell the property, it means that I will not pay tax to the Federal Government on the capital gains. And my basis is quite low in the property and, if I sell the property, I would have to pay a capital gains of approximately $1.4 million.

If I do not sell the property, there is no capital gains, and I do not pay anything.

It appears to me that the Government can help revenue enhancement by not limiting these sales; in fact, encouraging them. And I again would like to stress the Federal discount rate because the Fed rate is set primarily higher to slow the velocity of transactions. In times of distress, it is set lower to encourage the velocity. And I think this would be part of the intention of Congress in passing this act is to encourage or discourage transactions based on the then current economy.

Thank you and I will be glad to answer any questions later.

[The prepared statement follows:]

STATEMENT OF W. HAROLD COLLUM, CHAIRMAN, OVERSEAS SECURITIES CO., INC.

The government that governs least—governs best.

Under the current law, the minimum interest rate that must be used to avoid imputed interest by the IRS is calculated using a six month average. In today's marketplace, rates change so quickly that this method is already outmoded.

This annual rate is now 14.75% for mid-term debt (3 to 9 years.) This is much higher than institutional rates. By comparison, the mid-term market yield on government obligations on April 22, 1985 was 10.75%. This 4 point spread is unreasonable and extreme. Use of the bi-annual federal rate is inequitable and out of line with the marketplace. The rate used needs to be more in line with current market conditions. A means to accomplish this would be to use the federal discount rate—currently at 8%. If Congress fears that federal discount rate could float too low, a minimum floor could be instituted, say 9%. Or a flat percentage could be added to the federal discount rate.

True, this 9% is less than current institutional rates. But, individuals are not financial institutions nor do individuals have the means or wherewithal to commend such high rates.

From the individual's viewpoint, the 9% return on real estate debt is reasonable. If he had received cash instead of the note, today he could invest it in safe, conservative mid-term investments, yielding from 8½% to 10¾%.

His note should be considered safe, because the collateral is property which he once owned and liked. And, if he had to take it back, he would have basis of less than he sold it for because he had also received a down payment.

Forcing an owner to charge an unrealistically high interest rate will definitely slow the sale of real estate. When a property is not sold, there is no taxable revenue to the government.

The more attractive these sales, the more volume there will be and therefore more revenue for the government.

I understand some guidelines are necessary to avoid unrealistically low interest rates intended solely to change ordinary income into capital gains.

But, I ask you to consider making these controls as reasonable as possible to avoid interfering with the sale of property and, ultimately, the slowing of tax revenues received by the Federal Government.

Certificates of Deposit rates per the Wall Street Journal for 6 month CDs are 8.25%; for 1 year CDs 8.75%, (Monday, Aril 22, 1985, WSJ.) A Fed discount rate+1% currently would eqaual 9% which in my opinion would be a reasonable rate.

Government should try to increase trade, not restrain it.

Business and economics work best when free of controls, or as free as possible.

Therefore, I ask you to seriously consider and then adopt a rate tied to a current market rate. A rate based on a lagging indicator is usually too high or too low. Either way neither the government nor the real estate industry is well served.

Thank you.

Mr. **Matsui**. Thank you, Mr. Collum.

Mr. Sama, may I ask you a question?

Mr. **Sama**. Yes.

Mr. **Matsui**. The workout agreements that you refer to in the event of a default, or where there is an existing debt situation, now has that been interpreted by the IRS as not being a modification and, therefore, not subject to the OID rules, or is that something that is up in the air?

Mr. **Sama**. I am not sure that the IRS has spoken to that issue at this point.

Mr. **Feuertstein**. If I might mention something here. We had, in fact, gone to Treasury some months ago and their view is that the arrearage note that MLC has in its workouts would be considered a modification of the assumption.

Mr. **Matsui**. Have they given a formal opinion?

Mr. **Feuertstein**. Nothing formal, but when tax counsel hears that from Treasury, it is enough to be concerned.

Mr. **Matsui**. It really is a critical problem?

Mr. **Feuertstein**. Yes.

Mr. **Matsui**. It is pending right now and it is almost on top of you.

Mr. Melcher has rather a broad approach in terms of not applying any of the rules we are speaking of to any debt instrument.

I suppose your recommendation, in the event we could not go with 217 is to deal with it in terms of those two provisions. Any workout agreements which are entered into by governmental entities holding, insuring or subsidizing the loan which arise in the resyndication of low income subsidized housing projects that carry below market interest rates and have debt service in arrears that, in and of itself, would take care of your problem if we included that in any legislation.

Mr. **Sama**. Yes. We would hope that would be included. It certainly would assist us.

Mr. **Matsui**. What are some of the typical modifications in your workout agreement? You did refer to the practice of the industry talking about the foreclosures. Are there any other provisions besides those?

Mr. **Sama**. Those were the basic provisions which are negotiated and included in the workout agreement.

Mr. **Matsui**. Would it be possible for you to provide to the committee a copy of such a workout agreement so we can look at it?

Mr. **Sama**. Absolutely. Absolutely.

[The following was subsequently received:]

NEW YORK STATE MORTGAGE LOAN
ENFORCEMENT & ADMINISTRATION CORP.,
New York, NY, April 26, 1985.

Hon. ROBERT T. MATSUI,
House of Representatives, U.S. Congress,
Cannon House Office Building, Washington, DC.

DEAR CONGRESSMAN MATSUI: I appreciated the opportunity to speak before the House Ways and Means Committee on April 24, 1985 concerning the effect of the Original Issue Discount (OID) rules on our low-income housing loans.

As I indicated in my testimony, our Corporation administers a portfolio of $1.2 billion of such loans, of which there are debt service arrears in excess of $140 million.

In order to attract investors to troubled, low-income subsidized housing projects, it is critical that "work-out" agreements not be treated as modifications of the assumed debt obligations, since such treatment would subject the debt obligations to the OID rules.

We urge you to exempt all assumptions of loans relating to low-income housing from the OID rules. As a more restrictive alternative, we would urge that the definition of "modification" exclude from its coverage all "work-out" agreements (1) which are entered into by a governmental entity holding, insuring or subsidizing the loan and (2) which arise in the resyndication of low-income subsidized housing projects that carry below-market interest rates and have debt service in arrears.

In the absence of the above consideration for low-income housing, our projects will deteriorate in their financial and physical condition, and the ultimate cost will be borne by taxpayers at the federal and state level.

At the request of your Committee staff, I have enclosed a copy of a work-out agreement involving a modification of our debt service obligation. Similar workouts and resyndications of our troubled projects (with debt service arrears) have not occurred since the passage of the OID rules. We hope you can help remedy this serious problem.

Sincerely,

VINCENT J. SAMA,
Executive Vice President.

[NOTE.—The attachment referred to, "Workout of Certain Defaults in Respect of the Charlotte Lake River Residential Project," Vol. 1, April 16, 1982, has been retained in the committee files.]

Mr. MATSUI. OK.

I would like to ask Mr. Tapajna, in your experience with Arthur Andersen, have you found that, at a time when we do have high interest rates and instability in the financial markets that that is when seller financing occurs more often, or is it pretty much across the board, irrespective of the state of the economy?

Mr. TAPAJNA. I think that in periods of high interest, seller financing is more prevalent, at least in our experience. It depends an awful lot on the type of property involved, whether it is an existing property that has sufficient cash flow; a troubled property; developmental property, et cetera. While I agree with your generalization I would be able to point out exceptions to it.

Mr. MATSUI. Have you found—and I guess I cannot really ask you a percentage rate or anything like this because it may be unfair. Your situation may not be typical, but have you found much abuse of the situation where ordinary income is converted to capital gains, or is this something that occurs occasionally, but is not really a problem that people are really attempting in good faith to deal with it economically?

Mr. TAPAJNA. In my experience, I have not found a lot of capital gain conversion situations in the real estate arena. Probably the most prevalent abuses as noted by the Treasury Department and the various congressional staff in their writeups on the legislation, have been the acceleration of interest expense through noneconomic methods of allocating interest among periods that debt is outstanding. And we certainly agree with the provisions in the law that allocate interest on an economic basis.

Mr. Matsui. I want to thank all five of you for appearing here today. Your testimony was extremely helpful to us, and we will continue to be in touch.

Thank you very much.

Mr. Tapajna. Thank you.

Mr. Matsui. The hearings are adjourned subject to call.

[Whereupon, at 2:10 p.m. the hearing was adjourned.]

[Submissions for the record follow:]

Statement of the California Association of Realtors

Testimony is submitted by the California Association of Realtors, a trade organization representing over 103,000 real estate licensees. We commend the Chairman for holding these hearings and for providing an opportunity to discuss permanent imputed interest/seller financing tax rules.

The imputed interest provisions contained in the Deficit Reduction Act of 1984 have been the subject of intense controversy since their enactment. The Deficit Reduction Act contained substantial changes affecting the taxation of seller-financed real estate transactions. Under previous law, a seller of real property financing a transaction was required to charge the buyer at least 9 percent interest. If a lower interest rate was utilized, then the IRS could "impute" interest to the transaction and tax the seller as 10 percent interest has been received. It was the perception of the Treasury Department that these rules allowed sellers to inflate the selling price of property in return for providing low interest financing to buyers. Additionally, Treasury also objected to the use of accrued interest which could allow buyers to claim current interest deductions for interest accrued but not paid until a future date. In response, Congress (at the Treasury's urging) enacted the following rules, initially designed to become effective January 1, 1985, but delayed by later legislation: also our belief that total implementation of the Deficit Reduction Act would substantially disrupt, and in many cases entirely stop, many economically motivated seller-financed real estate transactions.

We congratulate members of this Committee and others in Congress for providing helpful legislation to mitigate the impact which would have resulted to the real estate industry, and to the overall economy, had these rules been allowed to totally take effect as originally scheduled January 1, 1985. However, the stop-gap legislation enacted late last year which maintained reasonable interest rate rules for many seller financed real estate transactions expires July 1, 1985 and we urge Congress to promptly address this issue.

If Congress does not act by July 1, then all seller financed sales of multifamily and commercial properties plus sales of principal residences costing more than $250,000 and farms costing more than $1 million will be required to charge interest equal to 110% of the applicable federal borrowing rate. This means that a seller of real property taking back all or any part of the financing for 10 years must charge the buyer 110% of the rate which the Federal government pays on 10 year obligations. Even with the recent decline in interest rates and the new AFR's, this requires sellers to charge 13.06% interest. Last summer the long term federal borrowing rate itself was 13%—meaning an owner would have been required to charge a buyer at least 14.3% interest.

Against this background, these rules need to be permanently addressed before they become fully effective July 1, 1985.

RECOMMENDATION

In conjunction with the National Association of Realtors, all the California Association of Realtors strongly supports the legislative solution to the imputed interest issue contained in H.R. 2069 introduced by Representative Bob Matsui and S. 729 authored by Senator Dave Durenberger. This solution would ensure the continued availability of seller financing at reasonable interest rates and all economic environments.

This Matsui legislation will accomplish the following:

On amounts of seller financing up to $4 million per transaction, the test interest rate shall be either 9 percent or 80 percent of the AFR, whichever is lower. Further, in the event that the test interest rate is not met, the imputed interest rate shall be either 10 percent or 90 percent of the AFR, whichever is lower.

On amounts of seller financing in excess of $4 million per transaction, the test interest rate shall be 80 percent of the AFR and the imputed interest rate shall be 90 percent of the AFR.

The Imputed Interest and Original Issue Discount rules will not apply to assumptions of loans or to loans taken "subject to", regardless of when the loan was originated.

In Wraparound Financing, Contracts for Sale, Contracts for Deed or similar all-inclusive debt instruments, the imputed interest and original issue discount rules will apply only to that portion of the debt taken back by the seller exclusive of any underlying debt. The test interest rate shall be measured against the actual rate of return on the seller's equity.

Transactions below $4 million of seller financing shall be excluded from the original issue discount provisions. However, buyer and seller will be treated as being on a cash/cash accounting method unless they agree to account for the transaction on an accrual/accrual method.

Transactions of more than $4 million of seller financing shall be subject to the original issue discount rules.

DISCUSSION

For many years, the ability and willingness of owners to finance sales of residences, farms, multifamily dwellings and businesses at affordable interest rates has enabled people to continue to do business in spite of unaffordable rates charged by third party institutional lenders. This is especially true during high or rising interest rate periods. For example, during the high interest rate recession of 1982, 34 percent, or approximately 800,000 home sales nationwide involved seller financing and 41 percent of all farm sales involved seller financing at an average 11.8 percent interest rate. Seller financing was an equally important financing mechanism for commercial office buildings and multiple structures.

The Role of Seller Financing in California

Seller financing has played a critically important role in the California resale housing and real estate market since 1980. In fact, during 1981 and 1982, sellers became the primary source of real estate mortgage financing as a result of the virtual withdrawal of institutional mortgage lenders from the marketplace. In residential transactions, sellers provided the bulk of this financing at interest rates substantially below that which otherwise would have been required under the imputed interest rules included in the tax bill. In the absence of those rules, sellers were able to provide the only source of affordable financing for hundreds of thousands of households during the recession when institutional mortgage interest rates were in the range of 16 to 17 percent.

These sellers do not provide financing for tax avoidance purposes for which the tax legislation was originally proposed. Instead, the mortgage loans they provide address the critical housing affordability problems that California homebuyers face and thus, merely facilitate the sale/purchase of a home. Nor do sellers receive substantially higher prices for homes they finance. Previous studies by economists at the Bank of America, UC Berkeley, and other researchers have shown that below-market seller financing enhanced aggregate California home prices by only a margin of 3 to 5 percent during 1980 through 1982.

Role of Housing in the Economy and Impact on Tax Revenues

The tax rules adopted in 1984 will force the costs of mortgage financing higher—especially during periods of higher interest rates when other lenders have in effect withdrawn from the market—causing a loss of resale activity and as a consequence, declining general economic activity and governmental tax revenues. The housing sector plays a pivotal role in the California and U.S. economies: in addition to the direct economic value generated, housing activity has significant indirect economic impacts and generates substantial federal, state and local tax revenues. Both new construction and resale housing output totaled 14 percent of California's gross state product in 1983. Additionally, local and state tax revenues generated by the housing industry in California equal 3.1 billion in 1983. Both the direct economic benefits and the tax generating capabilities of housing and real estate activity however, have been jeopardized as a result of the provisions of the Deficit Reduction Act.

Tax Bill Impacts on Housing Costs

The higher interest rates imposed on seller financing under the new imputed interest rate rules will significantly drive up the cost of housing. Currently, the higher rate required under the imputed interest rules would increase average monthly housing costs by between 15 to 25 percent for those homebuyers not otherwise exempted under the rules. Because some 25 percent of all resale housing transactions, and all of the new housing sales, are not exempt in California, imposing such a substantial increase in monthly home financing costs will force tens of thousands of potential homebuyers in California out of the marketplace.

Most unfairly impacted are the buyers of single-family homes where the seller was no longer the owner-occupant at the time of sale for reasons including divorce, employment relocation or death. These buyers—many of them first-time buyers constitute nearly 22 percent of the state's resale market. They will face substantially higher financing costs, regardless of whether their home would otherwise have been exempted under the sales price exception provided in the new rules. The new tax rules also create hardships on sellers who take back financing and later find themselves initiating foreclosure on a unit for failure of the buyer to make the monthly loan payments—payments for which the seller, nevertheless, incurs a tax liability under the OID rules. Similarly, in distress sales, where the property is sold at a loss (or for less than was originally paid or financed) the seller retains liability for taxes due under the OID rules.

Not only will homebuyers face higher housing costs, but so will renters under the new tax law. The new provisions impact virtually all residential income property transactions—including everything from duplexes to huge apartment complexes—increasing debt servicing requirements substantially. Residential income property investors have depended heavily upon low-interest and deferred interest financing to make projects "pencil out" in recent years. Thus, the higher seller financing costs associated with the purchase of residential income property will, by necessity, be passed on to renters in the form of higher monthly rents. In those markets where these costs cannot be passed through to tenants, new construction and renovation of rental units will either cease or be severly curtailed. Ultimately, this decrease in the new supply of rental units will become a factor pushing rents even higher. In summary, without the adoption of permanent corrective legislation, the imputed interest rules passed by Congress in 1984 will become effective in July, and will:

force sellers to establish interest rates that reduce housing affordability and significantly impact transaction volumes;

adversely affect the provision of rental housing and have an upward impact on residential rents;

reduce investment in commercial/industrial real property and reduce economic growth; and

penalize those transactions accomplished by means of more affordable non-institutional financing (including wrap-around and related instruments).

ANCILLIARY ISSUES

Recently, there has been discussion about using an index other than the applicable federal rate to determine the required interest rate for "large-scale" transactions (defined in the Matsui and Durenberger bills as seller financing in excess of $4 million). The cost-of-funds index, which is based on the semi-annual report of lending conditions that S&Ls submit to the FHLBB, has been the subject of this discussion.

The advantages of the cost-of-funds index are: (1) it is slow moving; (2) borrowers perceive it to be fair; and (3) many lenders like it because it is easy to administer. The disadvantages to the cost-of-funds index are: (1) the index substantially lags market fluctuations which can be a disadvantage when rates are falling significantly; and (2) the index has historically never fallen significantly and will be subject to upward pressures by virture of ongoing deregulation and thrift institution financial instability.

In contrasting the cost-of-funds index with present requirements, we would note that selecting an appropriate index will require an entirely different concept than that embodied in the original imputed interest/OID legislation. Although initial research indicates that 80% of this rate is needed by the industry as an alternative to unaffordable third party institutional lender rates, further study is required. The cost-of-funds index may prove to be an acceptable index. However, any attempt to impose the cost-of-funds index with a margin would be unacceptable.

Lastly, the issue of "capital losses" should be addressed. It is our view that irrespective of the threshold, where a capital loss would otherwise result, the test interest rate should be 9 percent (or 80 of the AFR whichever is lower) and the imputed interest rate 10 percent (or 90 percent of the AFR whichever is lower). We urge the inclusion of such provisions in your ultimate legislation.

CONCLUSION

We urge Congress to adopt a solution substantially similar to that contained in H.R. 2069 by Congressman Matsui. Further, we would suggest that this legislation be adopted as soon as practical (and before July 1, 1985) to ensure that real estate markets can function effectively and that significant economic disruption is avoided.

We appreciate the opportunity to submit these comments.

JOINT STATEMENT OF THE CLUB CORP. OF AMERICA AND THE NATIONAL CLUB ASSOCIATION

I. INTRODUCTION AND SUMMARY

The Club Corporation of America ("CCA") is headquartered in Dallas, Texas, and currently owns and operates 165 social clubs located in 39 states. CCA and its clubs are for-profit stock corporations, which are fully taxable for federal and local purposes.

The National Club Association ("NCA") represents approximately 750 social clubs which are tax-exempt under Section 501(c)(7) of the Internal Revenue Code. It also represents about 250 private social clubs which are not tax-exempt, either because they have chosen taxable membership club status (under I.R.C. Section 277 and other statutes), or because they are for-profit stock clubs.

CCA and NCA submit this statement in order to set forth their objections to certain parts of the newly enacted Section 7872 of the Internal Revenue Code, dealing with imputed interest. Specifically, we submit that Code Section 7872(c)(1)(E) will yield little revenue, but will instead impede expansion and growth of social clubs and cause complex and costly administrative problems.

Section 7872(c)(1)(E) is a catch-all provision entitled "Other below-market loans." The provision is totally open-ended in definition and scope, and could subject thousands of types of oridinary-course-of-business loans to complex regulation and taxation. Unlike other parts of Section 7872 (e.g., intra-family loans), Section 7872(c)(1)(E) contains virtually no standard for inclusion or exclusion, but merely delegates that decision to Treasury Regulations. Many taxpayers have already come to Treasury with hitherto unknown types of bona fide but potentially covered transactions, and Treasury threatens to become swamped as limited staff try to separate "good" from "bad" below-market loans.

Nowhere would the adverse impact of Section 7872(c)(1)(E) be greater than on social clubs. Below-market loans from members constitute the main capital financing device for many clubs. They are the economic equivalent of ordinary equity financing, and constitute the main practicable financing device for for-profit clubs; even for non-profit clubs, loans are easier to administer than equity infusions in many instances.

Potential implementation of Section 7872(c)(1)(E) could stop in its tracks the growth of for-profit clubs, eliminating over 2,000 new jobs and $50 million in new construction per year. The statute could also seriously hurt the nonprofit club industry—which has been barely holding its own in recent years. The result could be an even greater loss of jobs and economic growth.

Moreover, Section 7872(c)(1)(E) could result in I.R.S. being deluged with millions of Form 1099's, each containing its own figures based on its own complex mathematical computation. I.R.S. Service Centers cannot handle their present burden of paperwork, and such forms are unlikely to be fully processed.

For these reasons, CCA and NCA vigorously urge repeal of Section 7872(c)(1)(E). Alternatively, we urgently request that the statute be amended to exempt: (i) all below-market loans to the extent they are less than $10,000; (ii) all below-market loans which are used for capital financing purposes and are not a substitute for the lender-member's payment of club dues and fees; (iii) all member loans to clubs which entitle the member to equity rights, such as voting and sharing of assets on dissolution; and (iv) required member loans to a club which are comparable in size and timing to required equity payments by similar clubs in the same retail trade area.

II. THE STRUCTURE OF SECTION 7872 OF THE CODE

Section 7872 of the Code provides detailed rules for the taxation of certain types of "below-market" loans. The enactment of the statute was precipitated by below-market loans among family members; from employers to employees; and from corporations to shareholders.[1] These situations are covered by Section 7872(c)(1)(A)-(C) of the statute. Further, Section 7872(c)(1)(D) covers below-market loans one of whose principal purposes is tax avoidance. These provisions do not affect CCA or NCA clubs, and we take no position on them.

However, Section 7872(c)(1)(E) describes an additional class of below-market loans covered by the Statute, termed "Other below-market loans." This class is broadly described to be "any below market loan * * * if the interest arrangements of such loan have a significant effect on any Federal tax liabilities of the lender or the borrower." Section 7872(c)(1)(E) gives the Treasury Department authority to issue legislative Regulations to determine which below-market loans are covered because they have a "significant effect on tax liabilities", and which are exempted. The statute gives no guidelines as to how these determinatins are to be made. There is no clue as to whether "significant effect" in Subparagraph (c)(1)(E) intends a qualitative or standard, or whether a relative or absolute quantitative measure is intended. The term "effect on tax liabilities" is also left open ended; indeed, a below-market loan could have a net positive "effect" on tax revenues and still be covered under the literal terms of Section 7872. As a result, the statute gives the Treasury Department virtually unfettered authority to adjudge the "rightness" or "wrongness" of hundreds or even thousands of types of below-market loans.

III. SECTION 7872 (C) (1) (E) POTENTIALLY ENCOMPASSES MYRIADS OF TYPES OF ORDINARY-COURSE-OF BUSINESS LOANS

These provisions hang like a sword of Damocles over the business community and society at large, including the billion dollar club industry. Throughout our economy, innumerable below-market loans occur daily, for thousands of sound business, non-tax reasons. So broad are the statutory terms that the Joint Committee Bluebook has found it necessary to opine that the statute should not cover loans by financial institutions in the ordinary course of their trade or business; insurance policy loans; government-subsidized loans; and below-market charitable loans by philanthropies.[2]

In our economy, individuals and businesses provide funds to others on a below-market-rate basis in probably millions of types of genuine, bargained for business circumstances. For example, banks and other business interests in a community commonly furnish CCA clubs some capital funds at below-market-rates, simply because they feel that a CCA club will improve the business community. Businesses provide below-market loans to suppliers to ensure a steady flow of supplies, finance inventory, help the supplier through hard times, etc. Depositors in effect loan funds to banks at passbook rates in order to obtain ease of access to funds. Banks require no-interest compensating balances from customers as security or accommodations. Down payments can be viewed as a form of interest-free loans. The list goes on and on. Only the most optimistic advocate of economic regulation by central government would vouch for the Treasury's ability to define and properly classify as "good" or "bad", under the meaningless statutory terms, the myriads of other types of below-market loans in the American economy.

The result is that Section 7872(c)1)(E) is a seriouis potential threat to the business and economic community, threatening to destroy viable and genuine business transactions at the mere stroke of Treasury's pen. If a particular type of below-market loan is determined to be subject to Section 7872, the consequences can be disastrous. The borrower may have to realize a large portion of the loan proceeds as taxable income in the year of the loan if it is a term loan. Whether the loan is a term or demand loan, the lender and borrower will find that they have become subject to complex and expensive provisions governing calculation of imputed income, withholding, reporting, and recordkeeping. Where a type of below-market loan is repeated in the ordinary course of business, the administrative complexities and burdens of coverage under Section 7872 can make the transaction impracticable. Thousands of complex, disparate calculations (200,000 for CCA alone) must be made; I.R.S. Form 1099's must be sent to each lender; and the imputed interest rules must be explained to customers or suppliers. In many cases, these complexities will simply make a transaction unfeasible.

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[1] See H. Conf. Rep. No. 98-861, 98th Cong., 2d Sess. 1011-1019 (1984).

[2] General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, p. 532.

The administrative problems in Treasury's implementation of Section 7872 are also formidable. The Treasury and I.R.S. have already experienced continuing delays in issuing Regulations or other guidelines. Temporary Regulations were predicted last year, but numerous delays have ensured, and the Tax legislative Counsel recently quoted a date of Summer 1985 for the first Proposed or Temporary Regulations.[3] It is unlikely that such Regulations will even address the class of "Other below-market loans."

IV. SECTION 7872(C)(1)(E) COULD FATALLY IMPAIR THE FINANCING OF FOR-PROFIT CLUBS

In the case of CCA and other for-profit clubs, application of Section 7872 to their ordinary-course-of-business financing arrangements would be unfair and cripple their growth. In order to understand why this is so, it is necessary to understand how CCA finances its tremendous capital growth. CCA started with one club in 1957, and has grown by constructing new clubs, and acquiring established clubs which were in economic distress. It has expanded and prospered by extending club membership to moderate income persons. CCA clubs have succeeded by selling club memberships on the basis of quality services at reasonable prices, rather than relying on exclusivity of access or luxurious facilities.

Members purchase club services from CCA clubs like they purchase other services in the marketplace. CCA furnishes food, beverages, and other club services at ordinary, competitive prices. In 1984, members and guests of CCA clubs paid over $98 million in dues, and over $103 million for food, beverages, parties, and other fee services. Average monthly dues were $41.53 for city clubs and $74.73 for country clubs.

The above charges were for current services, however, and did not cover the capital costs of CCA clubs, such as the construction, renovation, and replacement costs. If CCA's dues and fees were to cover such capital costs, they would not be competitive with competing tax-exempt clubs, which usually pay capital costs from equity contributions. CCA accordingly finances its capital costs with 30-year, no-interest loans which members make when they join. Commercial loans cannot finance most of CCA's capital needs, because every bank lender demands that a borrowing club obtain substantial financial commitments from the club members in the form of loans, to ensure that the members will continue to patronize the club and pay sufficient dues and fees to service the bank debt. In 1983, the average member loan was $607; total member loans made in that year by new members totaled about $19 million.

CCA has been enormously successful in marketing club services to the general population. It started with one club in 1957, and has doubled in size every three to five years. Consistent with past growth, CCA projects its future expansion as follows:

[Dollars in millions]

	1984	1988
Number of clubs	159	350
Gross receipts	$262	$500
Operating profits	$9.0	$21.0
Employees	8,000	20,000
Taxes	$12	$19

Over $250 million in construction and renovation is projected during the next 5-year period.

This enormous past and future growth is an important component in stimulating the nation's economy, and in generating the federal, state and local tax revenues paid by CCA and its employees. However, application of Section 7872 to the capitalization of these clubs—a capitalization undertaken by the customer members in arms-length business arrangements with CCA proprietary clubs—would impair or even halt this thriving consumer industry.

2. Member loans to for-profit proprietary clubs like those of CCA do not have a significant effect on the tax liabilities of the members or the clubs. Member loans to CCA clubs arise out of an ordinary business transaction between unrelated service

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[3] See April 15, 1985 Tax Notes, p. 229.

providers and customers. Banks absolutely require the subordinated member capital furnished by such loans, as a prerequisite and as security for the capital furnished through commercial loans. No-interest member loans are essential to allow for-profit taxpaying clubs to compete with tax-exempt clubs, which obtain much of their capital from nontaxable equity contributions. Thus, in economic effect, these loans are really quasi-equity infusions from members.

No-interest member loans do not involve any tax avoidance. The loan funds merely represent a recreational asset in which the member chooses to invest in an ordinary business transaction. If the member did not make the loan and join the club, he would just as likely purchase some other recreational asset, such as a boat, a patio, exercise equipment, or the like, which would generate no taxable income. In spite of the member loan, the club member still pays ordinary dues and fees for services, which CCA, as an entrepreneurial owner, prices to sell at the highest levels which the market will bear. Such dues and fees are fully taxable to CCA.

Most importantly, application of Section 7872 to CCA's member loans would not produce more tax revenues, but would merely make club membership prohibitively expensive, dry up the prime source of capital to proprietary for-profit clubs, and drive customers elsewhere for recreation. In short, the application of Section 7872 will produce less tax revenue. Here is the scenario:

a. Each CCA club requires a certain amount of capital in order to be built.

b. If a major portion of this capital is taxed by application of Section 7872, one of two things will happen:

i. The tax will reduce the capital generated so that new clubs cannot be built; or

ii. CCA will have to increase the dues charged incoming members to artifically high levels (above the competition's) to end up with the same after-tax dollars needed to build the club. At such high dues levels, prospective members won't join and the clubs won't be built.

c. Without new clubs being built, the vehicle for creating taxable revenues ceases to exist. Tax revenues do not grow in a stagnant or declining industry.

In addition, the computation and reporting costs of applying the statute to CCA's prospective 200,000-plus members—not to mention the member confusion at being taxed on unearned income—would be an enormous burden on this business.

3. We have carefully reviewed the financial statistics for a number of CCA clubs over the past 10 years, and have projected the amount of extra bank debt and current income which they would have needed assuming Section 7872 had applied and imputed dues income to the clubs. We are convinced that these clubs could not have been built if Section 7872 had been so applied. Cash flow would have been severely reduced and would not have supported the higher debt service requirements. Accordingly, CAA would not have taken the additional risks, nor would the banks have made the required additional short-term operating loans.

For-profits proprietary clubs like CCA primarily exist to maximize profits for their owners, and compete in the marketplace with restaurants, bars, health clubs, hotels and other taxpaying businesses, as well as the nonprofit clubs. CCA's intent is thus to maximize every source of revenue, within competitive constraints, not to bestow tax benefits on unrelated members. In such circumstances, examples of abuses in the statute or committee reports, involving related parties (e.g., corporation-shareholder), should not be extended to cover ordinary commercial transactions—like member loans to clubs—through the catchall "Other below-market loans" provision of Section 7872(c)(1)(E).

Member loans are, in fact, the only practical competitive tool that CCA can use which can act as a close equivalent of the capital contribution made by an incoming member in a not-for-profit club—most of which are tax-exempt by statute.

Indeed, in the case of CCA, as in the case of most businesses, below-market transfers of all types are everyday occurrences. For example, banks sometimes loan CCA funds at below-market rates for many reasons—e.g., to increase traffic in a bank-owned or occupied building. Landlords frequently provide below-market rent to CCA clubs for the similar reasons. These and other below-market transactions have nothing to do with tax avoidance, and should not be shackled and stifled with the bureaucratic complexities and restrictions of Section 7872.

If Section 7872(c)(1)(E) is not repealed or amended, accountants and lawyers for for-profit clubs may require clubs to note enormous contingent liabilities on financial statements. Banks will be reluctant to participate in co-financing programs with members because of the potentially large tax liabilities of clubs. Many capital projects will simply be dropped because of the expansive language of the statute. No matter how urgent the below-market financing, members and other potential lenders may become unwilling to risk below-market loans to clubs in view of the broad language of the statute.

V. SECTION 7872 (C) (1) (E) MAY GRIEVOUSLY IMPEDE THE FINANCING OF TAX-EXEMPT CLUBS

The "Other below-market loans" provision in Section 7872(c)(1)(E) may also have serious and substantial adverse effects on nonprofit social clubs. The provision could be interpreted to cover a wide variety of club financing arrangements. For example, it may apply to: (i) below-market, required member loans to pay for clubs' construction and other capital costs; (ii) required member equity payments to clubs to finance capital projects; (iii) hybird forms of debt-equity payments typically paid by members as capital contributions; (iv) security deposits needed to ensure payment of club dues and fees. Such an interpretation would cause grave injury to tax-exempt clubs. Under Section 7872(c)(1)(E) as it now reads, there is a great deal of uncertainty as to its application to member capital financing of tax-exempt clubs.

VI. RECOMMENDATION FOR REPEAL OR AMENDMENT OF SECTION 7872 (C) (1) (E)

In summary, Section 7872(c)(1)(E) could have disastrous effects on the capital financing arrangements of social clubs. For this reason, CCA and NCA wholeheartedly recommend repeal of this provision.

Even if the Ways and Means Committee failed to recommend repeal of Section 7872(c)(1)(E), it should substantially limit its scope to situations where a below-market loan clearly results in a substantial diminution of federal tax revenues. In this respect, we suggest the following amendments to Section 7872(c)(1)(F).

1. A below-market loan from a member-club-lender, to a borrower would not be subject to Section 7872 to the extent that such loan is $10,000 or less.

2. A member's below-market loan to the member's club will not be subject to Section 7872 if the loan proceeds are designated and used for capital items, rather than as a substitute for current dues or other current fees.

3. A member's payments to a club which entitles the member to equity rights, such as the right to vote or a greater share of the club's assets on dissolution, should not be subject to Section 7872.

4. A member's below-market loan to a club should not be subject to Section 7872 if it is comparable in size and timing to equity payments or below-market loans of other clubs in the Retail Trade Area in which the club is located.

COOPERS & LYBRAND,
Washington, DC, April 29, 1985.

Hon. DAN ROSTENKOWSKI,
Chairman, House Committee on Ways and Means, House Office Building, Washington, DC.

DEAR MR. CHAIRMAN: We are submitting this statement for inclusion in the Committee's record for the April 24, 1985 hearing on the treatment of imputed interest in deferred payment sales of property.

Coopers & Lybrand is an international accounting firm, with 95 offices throughout the United States. A major part of our role in the National Tax Office of Coopers & Lybrand is to advise our practice offices and our clients on compliance and planning aspects of new legislation and IRS regulations, rules and procedures. We have, therefore, spent a considerable amount of time analyzing the relevant Code provisions and legislative history that were the subject of the April 24, 1985 imputed interest hearing and an even greater amount of time responding to questions and attempting to answer to a variety of issues raised by our practice offices.

Based on our experience with the imputed interest provisions and the comments, questions and concerns raised at the April 24, 1985 hearing, we have attempted to provide an objective analysis of the current proposals before the Committee so that acceptable permanent revisions to the imputed interest rules may be enacted. We have focused our analysis on two areas, the effects of a cash-cash matched accounting system and a lower imputed interest test rate. We have also commented on the economic accrual of interest.

Our recommendations and observations are as follows:

1. A cash-cash matched accounting system (as well as an accrual-accrual system) should be allowed for *all* seller financing transactions. With appropriate policing provisions, Congressional policy objectives may be achieved without overly burdening commercially viable sales transactions.

2. A reduction in the test and imputing interest rates may not result in unwarranted tax benefits. In fact, higher test rates may generate greater tax deductions as the term of the loan decreases.

3. Although the economic accrual of interest computation is somewhat complex, we agree that it is necessary to avoid the front-end loading of interest deductions.

A. BACKGROUND AND INTRODUCTION

The imputed interest provisions contained in the Tax Reform Act of 1984 (the Act) were intended to further integrate time value of money concepts into the federal tax system. The provisions were enacted to curtail excessive unintended tax benefits and restrict abusive tax shelters by (1) eliminating the distortions caused by the mismatching of income and deductions by lenders and borrowers in discount lending situations; (2) preventing the mischaracterization of income by manipulating the principal amount of the debt; and (3) preventing the use of a noneconomic formula in computing interest deductions.

Initial attempts to implement the new provisions have been fraught with controversy as the breadth and complexity of the provisions have been more fully realized. The negotiation of sales transactions has been hindered. In particular, the uncertainty created by the provisions have had a deleterious effect on the sales of real property.

In response to the controversy over these new imputed interest rules, Congress passed stopgap legislation in October, 1984. One of the primary effects of this legislation was to reduce the test and imputing interest rates. Now the Congress must determine how to implement the new provisions on a permanent basis in a way which achieves its policy objectives without undue complexity and without overly burdening commerically viables sales transactions. Our statement addresses the three major policy objectives of the provisions and we have suggested alternatives for the Committee's consideration where we believe the objectives can be better achieved.

B. MISMATCHING OF INCOME AND DEDUCTIONS—CASH-CASH ACCOUNTING SYSTEM

Congress believed that the mismatching of interest income and interest deductions, where the seller was on the cash method and the buyer on the accrual method, had serious revenue consequences because the present value of the deferred income included by the lender in the later period was substantially less than the present value of the deductions currently claimed by the borrower. Accordingly the Act requires a mandatory accrual method for buyers and sellers in discount lending transactions.

As recognized by the Joint Committee,[1] the mandatory accrual method presents a problem to sellers in discount lending transactions in that interest income must sometimes be recognized without receiving the related cash interest payment.

We believe that the cash-cash matched accounting system between buyers and sellers equally prevents the mismatching of interest income and expense among the original buyer and seller without hindering certain sales of property. The cash-cash method should be an alternative to the mandatory accrual method as an item to be determined by negotiation between the buyer and seller. By limiting interest deductions to those which have economically accrued, a cash-cash system will never generate total deductions in excess of the mandatory accrual system. Also, using one system like cash-cash for all transactions, with a joint election to use an accrual-accrual method, would be less complex and better reach your policy objectives than a situation where transactions under some dollar threshold are on one system and those over it are on another.

However, we recognize that there is a potential for unintended benefits under a cash-cash matching system necessitating rules to prevent such benefits and other possible abuses. The Joint Committee has expressed concern that abuses could arise under a cash-cash matched system if the obligation were subsequently transferred to an accrual basis purchaser or tax exempt entity. We believe similar problems exist with respect to an accrual-accrual matched system where the obligation is transferred by the seller to a cash method taxpayer or tax exempt entity. Both problems can easily be resolved by providing a rule that the original election of a matched accounting system follows the obligation on any transfer by buyer or seller.

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[1] References to the Joint Committee statements or positions are per "Description of the Tax Treatment of Imputed Interest on Deferred Payment Sales of Property" prepared by the staff of the Joint Committee on Taxation, April 23, 1985.

The Joint Committee has also expressed concern that a seller may borrow against a cash-cash obligation and thus shelter unrelated income. This potential abuse may be prevented by applying rules already established in the Internal Revenue Code in the area of borrowing to purchase or carry tax-exempt obligations and market discount bonds. In addition, the current prepayment of interest rules and the economic accrual of interest limitations will prevent other potential abuses.

In conclusion, we believe that a cash-cash matched accounting system for all transactions, with appropriate policing provisions, will acheive your policy objectives without overly burdening commercially viable sales transactions. Many of the policing provisions are already contained in other provisions of the Internal Revenue Code and thus should not be overly burdensome or complex in their implementation. Furthermore, a cash-cash system for all transactions would avoid the need for a complex set of aggregation rules. We also recommend that an accrual-accrual system, if elected by both the buyer and seller, should also be allowed.

C. MISCHARACTERIZATION OF INCOME—TEST AND IMPUTING RATES

Congress believed that it was possible for taxpayers in a sale of nontraded property for nontraded debt to achieve unwarranted tax benefits by manipulating the principal amount of the debt. This mischaracterization of interest as principal resulted in an overstatement of the sales price and the tax basis of the property. In cases where the property was a capital asset in the hands of the seller, interest income could be essentially converted to capital gain. If the property were depreciable in the hands of the purchaser, excessive cost recovery deductions could be claimed.

To eliminate this mischaracterization of income, the fair market value of the property must be determined. Congress believed that this valuation problem could best be resolved by valuing the debt instrument rather than valuing the property. The mechanism for valuing the debt instrument is the test interest rate. Should the debt instrument not meet the test rate, a new issue price is determined using a higher imputing interest rate (under the Treasury revised proposal, the test and imputing rates would be equal). The test and imputing rates essentially determine three important tax attributes: 1) the sales price; 2) the depreciable basis of the property; and 3) the interest income and expense to be reported.

The Joint Committee has provided examples (pages 16 to 18) of the potential and purportedly abusive overstatement of depreciable basis using a test rate of 80 percent and 100 percent of the AFR compared to an assumed market rate of interest of 110 percent of the AFR. We believe that such examples are somewhat misleading as they fail to truly examine the net tax benefits and related tax planning upon the acquisition of depreciable property.

A buyer of depreciable property recognizes tax benefits from both depreciation and interest deductions. As the test rate increases, the total amount of depreciation is reduced (i.e. the basis of the property is reduced) and the total amount of interest deductions is increased (i.e., the interest rate is higher). The Joint Committee examples ignore the effects of the increased interest deductions as they assume that the buyer and seller are in 50 percent tax brackets and accordingly that the interest amounts have no effect on tax revenues. However, this assumption should be reexamined.

It is often the case that a seller of property is not in a 50 percent tax bracket. This may be due to tax exempt status, installment sale treatment, loss carryovers or simply other deductions. The Joint Committee later recognizes (page 27) a tax bracket differential where a tax-exempt or foreign entity may be involved. As a practical matter, the abuses in this area generally involve the acquisition of depreciable property by tax shelter investors and other high tax bracket taxpayers. Such taxpayers are interested in total deductions, not just depreciation deductions.

We believe the focus should be on the total deductions generated upon the acquisition of depreciable property and whether a lower test rate will yield significantly greater tax benefits than those under a 110 percent test rate. With this objective, we have reexamined the Joint Committee's examples analyzing the total deductions generated utilizing various test rates and have found that lower rates generally do not yield unwarranted tax deductions.

It must be emphasized that any analysis of the effects of higher or lower test rates must be made in light of general industry practice. Thus, it should be noted that most seller financing of real property is for a term of ten years or less. After such time, the property is sold or the seller financing is paid off with non-seller financing. Furthermore, most real estate investments are typically held for only a period of approximately eight to ten years.

With this in mind, a reexamination of the Joint Committee's examples indicate the following:

(1) The so-called basis overstatement and related depreciation deductions resulting from an 80 percent test rate, as compared to a 110 percent test rate, are to a great extent offset by lower interest deductions. For instance, a 25 percent basis overstatement on a 10 year note and an 80 percent rate results in only a 5 percent difference in total deductions. See Table III.

(2) When the term of the loan is from 5 to 10 years (i.e. a typical real estate loan in today's marketplace), the basis overstatement is substantially reduced. In fact, a 110 percent rate may generate greater total deductions where commercial (nonresidential) property is involved. For example, assuming a 7 year note and straightline depreciation (which is typical for commercial real estate) a 110 percent rate generates 3 percent more tax deductions after 8 years than under an 80 percent rate. The deductions are even greater when the loan term is 5 years. See Tables I and II and related graph.

(3) In many seller financed real-estate transactions, the purchaser is acquiring land as well as depreciable property. In these cases, the use of higher test rates often magnifies the tax shelter potential of the purchaser by allowing the purchaser to take higher interest deductions. See Tables III and IV.

In summary, a complete analysis of a purchaser's total tax benefits indicates that a decrease in the test rate, in today's real estate market, will not generate unwarranted tax benefits. It should also be noted that the above analysis can not quantify the increase in economic activity that lower test rates may generate.

It should be noted that the above computations are based on the Joint Committee's assumption that 110 percent of the applicable federal rate approximates the market rate in real estate transactions. At the April 24, 1985 hearing, representatives of the real estate industry challenged this assumption.

The Joint Committee supports the validity of the 110 percent rate by tables on pages 22 and 23 which compare the yield on 10-year United States Government Securities to Government Sponsored Mortgages and Mortgage-backed Securities. The comparison made by the Joint Committee is somewhat misleading, since it compares 10-year securities to much longer term mortgages and then makes assumptions with respect to the lender holding the mortgage to maturity.

D. ECONOMIC ACCRUAL OF INTEREST

Congress believed that significant distortions occurred under prior law in the form of noneconomic accruals of interest. To alleviate this concern, the Act provided that interest must be allocated to each tax accounting period in a manner consistent with the yield to maturity method. We agree that such interest computation method is necessary to avoid the front-end loading of interest deductions. However, it should be noted that the yield to maturity method is rather complex. Thus it may be appropriate to exempt certain small transactions from these rules.

E. CONCLUSION

In conclusion we believe the analysis and recommendations discussed above deserve the Committee's further attention as it searches for a clearer overall approach to the imputed interest provisions. We believe the Act's basic goals would not be compromised by these changes and that greater public support would result.

We sincerely appreciate this opportunity to submit our comments. Should you have any questions please do not hesitate to contact me or Mark B. Brumbaugh, a partner in our National Tax Consulting Office.

Sincerely,

IRA H. SHAPIRO,
Director of Tax Policy.

APPENDIX

ANALYSIS OF ALTERNATIVE TEST RATES

Summary of conclusions

1. When the loan term is less than 10 years, the 110% test rate will generate greater tax deductions (i.e. constitute a better tax shelter) than under an 80% test rate. It should be noted that most seller financing is for a period of less than 10 years.

2. When the loan term approximates 10 years, the 80% and 110% test rate generate approximately the same total deductions over the first 8 years. Eight to ten years is the average holding period of a real estate investment.

3. The Joint Committee's focus on the basis overstatement is misleading in that it fails to consider the total deductions, (i.e., depreciation and interest). Thus a 25% basis overstatement using an 80 percent rate results in only 5% greater total deductions.

4. The Joint Committee's computation of the basis overstatement is misleading as it assumes all basis is allocable to depreciable property. In fact, land, a nondepreciable item, is generally purchased with a building. The use of a higher test rate often magnifies the tax shelter potential of the purchaser.

Assumptions and observations

1. The following Tables are based on the same assumptions in the Joint Committee's analysis of the tax consequences of understatement of interest. In short the computations assume:

(a) A present value of principal and interest payments of approximately $100,000,000

(b) Current payment of interest and balloon payment of principal

(c) 110 percent of the April applicable federal rates are 13.49% for loan terms in excess of 9 years and 13.06% for loan terms between 3 and 9 years.

2. Depreciation deductions were computed on a straightline basis over 18 years which is typical of commercial (nonresidential) real estate. It should be noted that residential real estate is typically depreciated on an accelerated basis.

3. In today's market place, real estate investments are generally held 8 to 10 years. Thus it is important to focus on the total deductions over such period.

4. In today's market place, seller financing is generally for a period of 5 to 10 years. Thus it is important to focus on the tax deductions arising under such loan terms.

Legend

Depreciable Basis—Dollar amount allocated to depreciable property based on a present value of principal and interest payments of $100,000,000.

Total Deductions—Total amounts allocated to interest and depreciation over a 19 year period. Eighteen year real property depreciated on a straight line basis is generally written-off over 19 years.

Total Deductions in First 8 Years—Total interest and depreciation deductions in the first 8 years.

TABLE I.—TEST RATE COMPARISON, 5-YEAR LOAN TERM

[Dollar amounts in millions]

Test rate as percent of AFR	Depreciable basis		Total deductions		Total deductions in first 8 years	
	Total	Percent of 110 percent amount	Total	Percent of 110 percent amount	Total	Percent of 110 percent amount
80	$114.5	114.5	$168.9	102.1	$108.2	96.2
90	109.2	109.2	167.6	101.3	109.7	97.5
100	104.8	104.8	166.6	100.7	111.1	98.8
110	100.0	100.0	165.5	100.0	112.5	100.0

TABLE II.—TEST RATE COMPARISON, 7-YEAR LOAN TERM

[Dollar amounts in millions]

Test rate as percent of AFR	Depreciable basis		Total deductions		Total deductions in first 8 years	
	Total	Percent of 110 percent amount	Total	Percent of 110 percent amount	Total	Percent of 110 percent amount
80	$118.9	118.9	$198.0	103.3	$135.0	97.3
90	111.9	111.9	195.7	102.1	136.4	98.3
100	106.1	106.1	193.7	101.0	137.5	99.1
110	100.0	100.0	191.7	100.0	138.7	100.0

TABLE III.—TEST RATE COMPARISON, 10-YEAR LOAN TERM WITH ZERO ALLOCATION TO LAND

[Dollar amounts in millions]

Test rate as percent of AFR	Depreciable basis		Total deductions		Total deductions in first 8 years	
	Total	Percent of 110 percent amount	Total	Percent of 110 percent amount	Total	Percent of 110 percent amount
80	$124.6	[1] 124.6	$246.7	105.0	$156.2	100.8
90	115.4	115.4	242.3	103.1	155.8	100.5
100	107.5	107.5	238.7	101.6	155.4	100.3
110	100.0	100.0	235.0	100.0	155.0	100.0

[1] Amount differs from Joint Committee's 125 percent amount as Joint Committee rounded the 80 percent test rate from 9.78 percent to 9.70 percent.

TABLE IV.—TEST RATE COMPARISON, 10-YEAR LOAN TERM WITH 20 PERCENT ALLOCATION TO LAND

[Dollar amounts in millions]

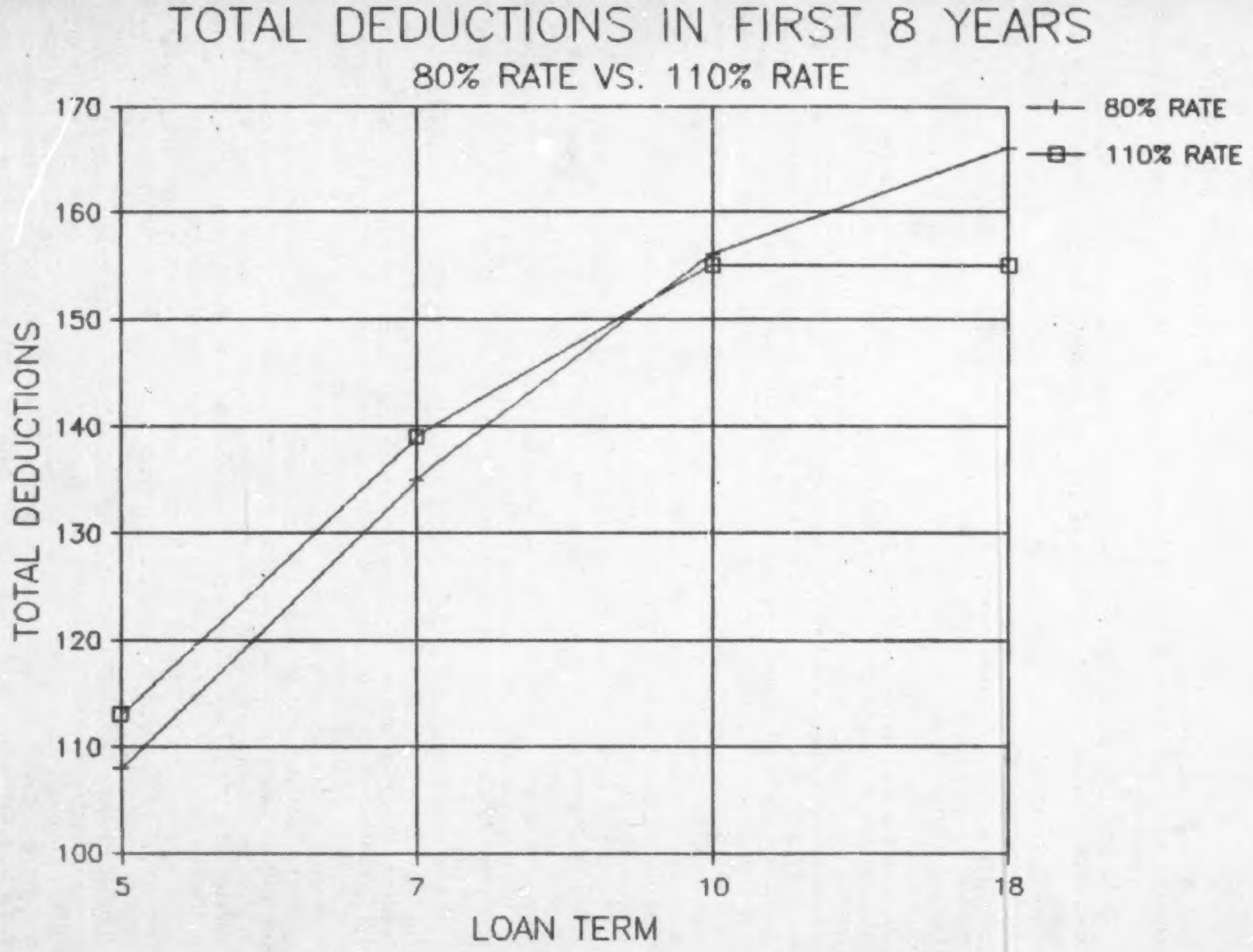
Test rate as percent of AFR	Depreciable basis		Total deductions		Total deductions in first 8 years	
	Total	Percent of 110 percent amount	Total	Percent of 110 percent amount	Total	Percent of 110 percent amount
80	$99.7	124.6	$221.8	103.2	$144.5	99.2
90	92.3	115.4	219.3	102.0	144.9	99.5
100	86.0	107.5	217.2	101.0	145.3	99.8
110	80.0	100.0	215.0	100.0	145.6	100.0

TABLE V.—TEST RATE COMPARISON, 18-YEAR LOAN TERM

[Dollar amounts in millions]

Test rate as percent of AFR	Depreciable basis		Total deductions		Total deductions in first 8 years	
	Total	Percent of 110 percent amount	Total	Percent of 110 percent amount	Total	Percent of 110 percent amount
80	$132.7	[1] 132.7	$366.6	106.9	$166.3	107.3
90	120.0	120.0	357.6	104.3	162.0	104.5
100	109.5	109.5	350.0	102.0	158.3	102.1
110	100.0	100.0	343.0	100.0	155.0	100.0

[1] Amount differs from Joint Committee's 133.4 percent amount as Joint Committee rounded the 80 percent test rate from 9.78 percent to 9.70 percent.


TOTAL DEDUCTIONS IN FIRST 8 YEARS
80% RATE VS. 110% RATE
80% RATE
110% RATE
TOTAL DEDUCTIONS
170
160
150
140
130
120
110
100
5
7
10
18
LOAN TERM

SYRACUSE UNIVERSITY,
COLLEGE OF LAW,
Syracuse, NY, April 18, 1985.

Hon. DAN ROSTENKOWSKI,
Chairman, Committee on Ways and Means, Longworth House Office Building, Washington, DC.

DEAR MR. CHAIRMAN: We welcome this opportunity to present our views on certain aspects of the proper treatment of deferred payment debt-for-property transactions.

By enacting sections 1272 through 1275 of the Code as part of the 1984 Deficit Reduction Act, Congress eliminated the exclusion of debt instruments issued for property from the original issue discount (OID) laws. Prior to the Act, issuers and holders of debt instruments in property-for-debt transactions achieved significant tax benefits by mismatching the timing of income recognition and the taking of deductions.[1] The 1984 legislation cured this abuse by extending the coverage of the OID rules to include certain transfers of property for debt, thereby subjecting those transactions to the section 1271(a) requirement that OID be taken into current income regardless of whether it has actually been paid.

Generally, exchanges of deferred payment debt for property are governed by sections 1273(b) (3) & (4) and 1274. Under these rules, the amount of OID involved in any given transaction varies according to both the type of debt instrument issued and the nature of the consideration involved. Of particular interest to the authors in this statement is the treatment of debt instruments in the publicly traded arena where section 1273(b)(3) determines the issue price. That subsection states that the issue price for any publicly traded debt instrument issued for property, or for any debt instrument (public or private) issued for publicly traded stock or securities shall be the fair market value of the property involved.[2]

The issuance of purchase money debt in exchange for property under section 1273(b)(3) presents a potential problem which is not readily answered by the law at present. In a section 1273(b)(3) transfer of a non-interest bearing purchase money note for property, the issue price equals the fair market value (FMV) of the property involved and thus the amount of OID present will hinge upon the stated redemption price (SRP). In situations where the SRP is equal to the issue price, there will be no OID.[3]

In this case, section 483 could arguably apply. Section 483(d)(1) can be read as precluding the section's application only when the OID rules actually produce OID—a reading which is internally consistent with the logical requirement of section 1272(a)(1) that there be OID present before the rule requiring current inclusion can apply. This reading, however, is not in agreement with the role of section 483 as expressed in the section's legislative history. From the committee reports, the role of section 483 can best be described as a safety net for transactions falling within one of exceptions to the OID rules set forth in section 1274(c)(4).[4] A fair reading in light of section 483's legislative history suggests that transactions coming within the purview of the OID provisions which have no OID were not intended to be included in the class of transactions to which the section was meant to apply.

The applicability of section 7872 to this type of transaction is also questionable. Section 7872(f)(8) states that the section shall not apply when either section 483 or 1274 is applicable. There is no mention, however, of the role of section 7872 in instances otherwise covered by the OID rules. Although an equity based argument can be made that section 7872 should back up section 1273(b)(3) in situations where no OID is produced upon application of the OID provisions, nothing in either the statute or the section's legislative history supports this result. The committee report reveals that the section was enacted specifically to deal with traditional loan situations as opposed to transfers of property for debt that encompass some of the elements of a straight loan transaction. Further, there is nothing in the statute itself to suggest that transfers of property for debt in the context of public trading should come within its scope.[5]

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[1] Section 483, prior to the 1984 Act, did not require the current inclusion in income of amounts properly classified under its rules as unstated interest. See I.R.C. § 483(a) (1984).

[2] In all other cases where debt is traded for property and which is not subject to section 1274, the issue price of the instrument equals its SRP at maturity. *See* I.R.C. § 1273(b)(4) (1985).

[3] This situation could be avoided if the parties agree to include one dollar of OID above the de minimis amount set forth in section 1273(a)(3). In that case, section 1272 would clearly apply.

[4] The committee report states that "section 483 will apply only in the case of deferred payment transactions involving sales of property which are exempted from the OID rules (e.g., sales of a principal residence; certain sales of farms transactions involving total payments of $250,000 or less; and transactions subject to section 483(g)). H.R. Rep. No. 432, 98th Cong., 2d Sess. 1250.

A more troublesome area involves sections 7872(c)(1) (D) and (E). These provisions make any loans having a principal tax avoidance purpose or having a "significant effect" on the federal tax liability of either the borrower or the lender subject to the minimum rate structure set forth in section 7872(f)(2). There is, however, nothing in either the legislative history or the statute itself that suggests a proper definition for this broad language and its effect on the type of transactions under discussion.[6] Apparently, the task of defining the terms and delineating the scope of these provisions has been left to the Treasury by virtue of section 7872(g). Such broad legislation gives the Treasury the power to, in effect, expand the law without the safeguards inherent in the legislative process and represents a dangerous proposition which, as a matter of fundamental tax policy, should be avoided.

We do not argue that section 1273(b)(3) transactions that produce no OID should not be taxed. On the contrary, these situations should be subject to the same rules as other substantively similar transactions that fall under section 1272. We do feel, however, that the extension of section 7872 in its present form to section 1273(b)(3) purchase money obligations issued for property is an improper means of achieving that end. Therefore, in the interest of consistency of treatment among deferred payment for property situations, we suggest the following alternatives be considered to remedy the problem.

First, the scope of section 483 could be expanded to include section 1273(b)(3) transactions when OID is not actually present. Although this result can arguably be achieved under the present statute, the result is in direct conflict with the role of section 483 as envisioned by the joint committee. A provision either mandating that the section 1272 exception be effective only when OID is actually present under the section 1272(a)(1) formula, or specifically including section 1273(b) (3) and (4) transactions not involving OID within the scope of the statute, will achieve equitable results and ensure that transfers of property for debt are governed by laws originally designed for such transactions.

As a second alternative, section 7872 could be amended either to bring purchase money transactions governed by section 1273(b) (3) or (4) within its scope or to specifically deny the applicability of the provision to such transactions.

We believe that either alternative would represent a positive step which would add certainty and consistency to the Code's OID provisions.

Sincerely,

MARTIN L. FRIED,
Professor of Law.
ANDREW C. WHITE,
Class of 1985.

STATEMENT OF THE IBM CREDIT CORP.

IBM Credit Corporation ("IBM Credit") is a wholly-owned subsidiary of International Business Machines Corporation, ("IBM"). This statement describes some presumably inadvertent problems which the imputed interest rules have created for IBM and IBM Credit and suggests solutions to them. These problems were briefly and generally identified in the April 24, 1985 statement to this Committee of Ronald A. Pearlman, Assistant Secretary (Tax Policy), Department of the Treasury ("Treasury Statement"), at pages 17 and 18. The solutions suggested in the Treasury statement, when fully implemented, would substantially solve the problems which section 1274 has created for IBM and IBM Credit. Generally, the solutions of this statement are conceptually consistent with the solutions of the Treasury Statement, but vary in certain particulars and suggest additional guidance in certain areas.

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[5] The only explicit mention of the OID rules is found in section 7872(f)(8) which simply requires that where either section 483 or 1274 applies to a transaction to which section 7872 applies, those sections will control the result. Given the broad definition of a debt instrument found in both sections 483 and 1275, there will necessarily be some overlap with the section 7872 provisions. But to argue that section 7872 should dictate the results in publicly traded debt for property transactions is, in our opinion, to have the tail wag the dog.

[6] Arguably, the fact that section 7872(c)(1)(E)'s broad language foresees application of the section to situations outside of those specifically enumerated in the statute suggests that a safety net effect was desired although not explicitly set forth. However, given the section's vague legislative history, it seems that Congress may have dealt with the current problem quite by accident.

IBM develops, produces, manufactures and sells data processing machines and systems, telecommunications systems and products, information distributors, office systems, typewriters, copiers, educational and testing materials, and related supplies and services. IBM Credit purchases and leases IBM products and purchases installment payment agreements ("IPAs") which result from installment sales of IBM products.

The Tax Reform Act of 1984, adding Internal Revenue Code section 1274, expanded the scope of prior Code provisions determining whether interest rates charged in certain seller financed transactions are reasonable. These modifications to the imputed interest provisions were intended to prevent a seller from artificially depressing the interest rate on an obligation issued in exchange for property while increasing the obligation's stated principal to achieve a greater investment tax credit for the buyer. However, in practice, the new imputed interest rules overreach their intended bounds and interfere with legitimate non-tax motivated business transactions.

Section 1274 creates a special problem for equipment manufacturers such as IMB who sell equipment in installment sales. The problem arises because the test interest rates, used to determine the existence of unstated interest on an obligation, at times may be higher than actual market rates used by IBM for installment obligations received in such sales. The rate that is charged on IBM's 4 and 5 year IPAs to large credit-worthy customers has in the past (see Illustration A) and may in the future fall below published testing rates. As a result, IBM and other manufacturers are placed at a competitive disadvantage with respect to third parties that are able to finance the purchase of the same equipment without regard to the imputed interest rules. When the testing rates are too high, a manufacturer must either raise its interest rates above market or subject its customers to a partial loss of investment tax credit.

The testing rates under section 1274 may be too high for four major reasons: (1) Testing rates for installment debt instruments may be determined by reference to the final maturity of the installment obligation ignoring the fact that most principal is amortized in advance of final maturity; (2) The application of only three testing rates for all maturities of debt instruments is an approximation which is too broad; (3) The testing rates lag market rates by an average of one-two months; and (4) Market rates for very credit-worthy customers may be close to or, in some cases, less than 110% of the applicable federal rate—in any event 110% of the applicable rate is just too fine-tuned for a system which approximates maturities and may be six weeks out of date.

DISCUSSION

The application of section 1274 to IBM installment sales gives a prime example of the shortcomings of the testing rates. IBM sells its products to customers at selling prices established under standardized pricing policies that do not vary depending upon whether the transaction is for cash or credit. In fact, the majority of its sales are for cash (some 89% of domestic new equipment sales in 1984).

Under the business relationship between IBM and IBM Credit, the interest rates charged on IBM's IPAs are determined by IBM Credit. IBM Credit purchases all of IBM's IPAs, and only the profits of IBM Credit are affected by the interest rates on installment sales. Conversely, IBM Credit's profits are independent of the selling price of IBM products. As an independent profit center, IBM Credit's management objective is to maximize profits from the financing and lease transactions in which it engages and not from the sale of IBM products.

IBM Credit sets the interest rates charged on IBM IPAs weekly, based upon current interest rates in the competitive market for financing. For transactions in excess of $1 million, rates are set based on market indices, currently the weekly average of the rates on 2, 3, 4 and 5 year Treasury bills, plus a step-up to reflect the credit of the borrower and the administrative costs of the transaction. The rates on IBM's IPAs therefore reflect the fact that principal on the obligations is repaid with each monthly installment, i.e., some principal matures in years 1, 2, 3, and 4 as well as in year 5.

Sections 1274 and 483 in their current form fail to adequately account for this self-amortization of installment obligations, despite an implicit Congressional recognition that market interest rates differ according to the maturity of a debt instrument, with higher interest rates corresponding to longer maturities. In enacting section 1274, Congress provided three different testing rates, dependent upon the "term" of the debt instrument. However, the word "term" could be construed to refer to the last maturity date of an obligation, without recognition of prior maturity dates. In the case of a balloon note, this construction would be reasonable. However, the word "term" so construed would not account for the amortization of principal over time that occurs in installment obligations.

As a result, the adequacy of stated interest on IBM's 5-year IPAs may be measured by a testing rate established by reference to 110 percent of the average rate on treasury obligations maturing in 4 through 9 years—a maturity much longer than the average 2.5 to 3 year maturity of the IBM 5-year IPAs. IBM's interest rates on certain 5-year IPAs for large credit-worthy customers at times were lower than the 4 to 9 years maturity testing rates under section 1274. Therefore, if section 1274 is applied to the IBM 5-year IPAs using the 4 to 9 year maturity test rates, it would require an imputed principal amount for these sales below IBM's ordinary cash price for similar products.

The use of only three testing rates, corresponding to short-term, mid-term, and long-term maturities, compounds the current inaccuracies in the determination of the applicable federal rate under Section 1274. For example, this broad approximation fails to reflect the differences in risk associated with a 4 year debt instrument and a 9 year debt instrument. Section 1274 therefore interferes with the normal market processes which assign higher interest rates to debt instruments with longer terms.

The testing rate described by section 1274 also interferes with the normal processes through which businesses set their market rates. Businesses which set rates on a weekly or even daily basis, to more accurately reflect the market, ironically may suffer the consequences which should be reserved for tax-motivated actions, because of the minimum 6-week time lag. Although Treasury's adoption of monthly alternate applicable federal rates has narrowed this problem, it remains a serious obstacle to the ordinary business practices of taxpayers that change rates more often than monthly.

Section 1274 also inappropriately penalizes sellers who set rates on the date on which the customer takes delivery of the purchased property. By statute, the testing rate must be set as of the date on which a binding contract for a sale or exchange exists. Businesses which set interest rates as of the date of the actual exchange of property therefore may fail to meet the testing rate solely because of a legitimate business choice.

Because of these inaccuracies in the testing rate, IBM might be forced to raise it installment sale interest rates above market or subject its customers to imputation of interest and the complexity of Section 1274, when the testing rate is too high.

The competitive situation facing IBM makes an interest rate increase burdensome. Purchasers may decide to finance the purchase of the product from other sources which do not fall within the ambit of section 1274, such as banks or other third party lenders.

If interest rates are not raised, the imputed principal amount established by section 1274 gives the installment sale purchaser a lower basis than that given to a cash purchaser of the same product. A lower basis decreases the benefit of the investment tax credit which the purchaser obtains, and therefore increases his cost of purchasing IBM products using IBM financing. Purchasers again could use other sources of financing including other third party lenders rather than IBM financing to achieve a basis equal to the cash price of IBM products.

Thus, in certain transactions, section 1274 places IBM at a competitive disadvantage vis-a-vis third party lenders and creates unwarranted inefficiencies for customers who want the convenience of IBM financing. Moreover, this undesirable result is reached through application of a tax-avoidance provision to non tax-avoidance business transactions. Furthermore, IBM's fact pattern illustrates the arbitrariness of the current imputed interest rates. Illustration A clearly shows that the statute has failed to be ". . . a reasonable approximation of the rate at which a good credit risk with adequate security could borrow." General Explanation of the Revenue Provision of the Deficit Reduction Act of 1984, H.R. 4170, 98th Cong., 2d Sess. 115 (n.24) (Jt. Comm. Prt. December 31, 1984).

For these reasons, section 1274 and the regulations thereunder should contain provisions:

(1) To exempt from the imputed interest rules for sales of new section 38 property when the seller, or member of its affiliated group, regularly sells substantially similar property [1] in cash transaction at the same price.

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[1] The Treasury Statement suggests a similar solution but uses the term "fungible" property. IBM Credit believes this term is too restrictive and could be construed to refer only to commodity products such as wheat, oil, etc.

(2) To ensure proper treatment of installment obligations, ideally by directing the Secretary to promulgate regulations to provide that the federal rate applicable to an installment obligation is determined by the obligation's average maturity.[2] Alternatively, each installment of principal could be categorized as a separate serial obligation according to its term.

(3) To set the test rate at 100% of the applicable federal rate.

(4) To allow taxpayers to use current bona fide published interest rates on outstanding obligations of comparable maturities as the testing rate. The burden of computation and proof would be on the taxpayer, who could establish that, as of the date of the sale or the date on which the binding contract was entered into, the debt instrument's stated interest rate was equal to or greater than the lowest yield on federal obligations of comparable maturity for the preceding week. This would simplify section 1274, and eliminate the need for Treasury to publish rates other than semi-annually.[3]

In recommending these proposals, IBM Credit is quite conscious of concerns about the complexity of section 1274. In the interests of "simplicity", section 1274 was drafted with a limited number of testing rates and limited changes in those rates, thus trading preciseness for "simplicity". However, in setting the testing rate at 110 percent of the applicable federal rate, section 1274 attempts too much precision for its imprecise framework. As a result, too many taxpayers are subjected to the complexity of section 1274 and the need to consider its provisions in connection with every day non-tax motivated business transactions. The simplicity gained by the broad brush approach of portions of the statute is offset because of the number of additional transactions which must be tested.

There are two ways to restore simplicity to section 1274: (1) It can be made more precise so that taxpayers dealing at market rates will not have to be concerned with imputed interest at all; or (2) It can be made sufficiently imprecise in favor of no interest imputation (for example, a test rate set below the applicable federal rate) that many transactions escape its ambit. In making these recommendations, IBM Credit has generally adopted the first approach.

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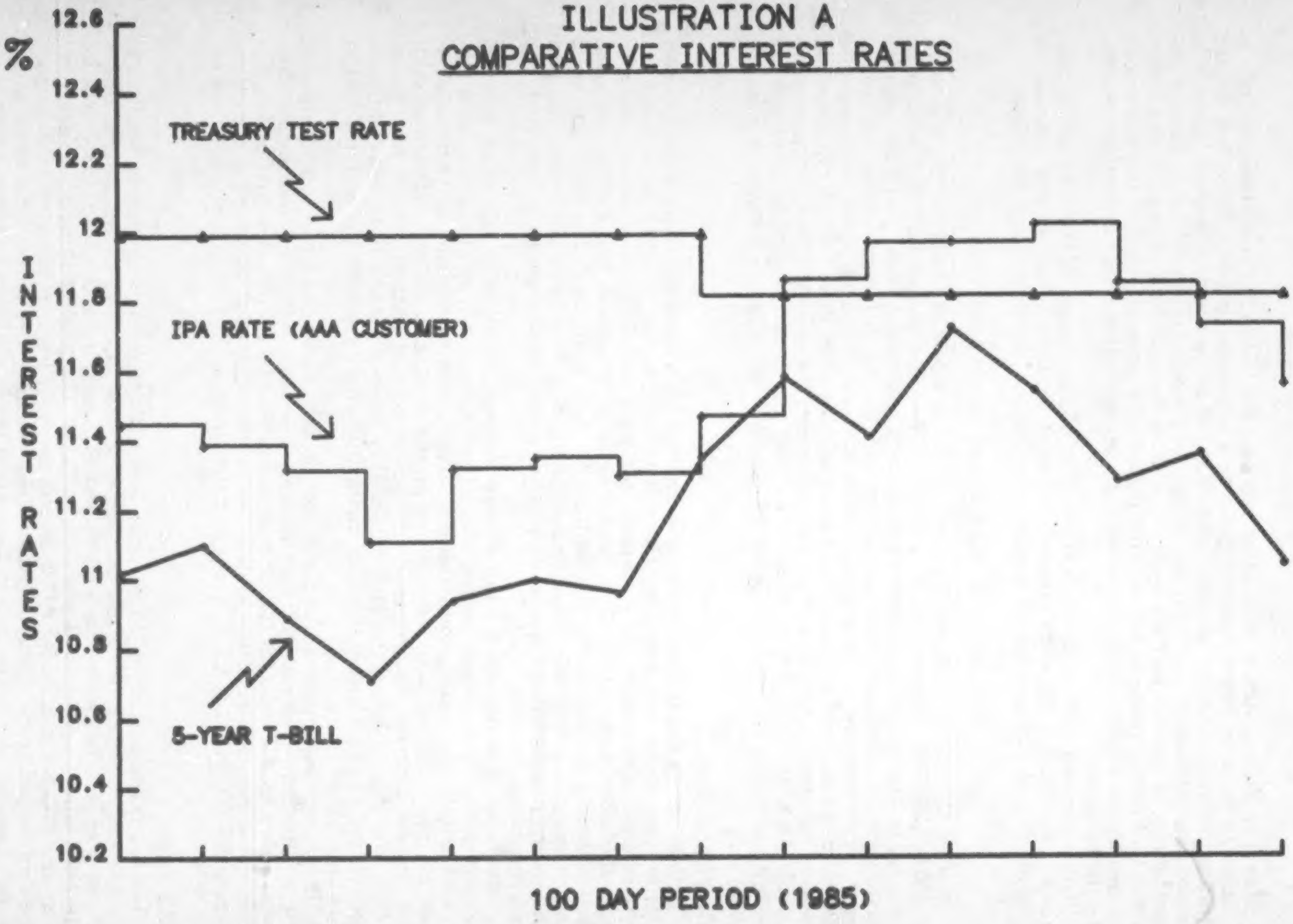
[2] The Treasury Statement does not specifically address the average maturity concept. IBM Credit believes that Treasury's proposal to allow taxpayers to establish the adequacy of stated interest under principles similar to those of section 1274, in concept, should permit use of average maturity for establishing the adequacy of the stated interest rate, but specific immediate guidance on the point is needed.

[3] This solution is consistent with the Treasury Statement's solution that would allow taxpayers to establish the adequacy of interest rates based on the same principles as those of section 1274. However, IBM Credit believes that it is appropriate to provide further flexibility by specifying that the adequacy of the stated interest rate may be established, as an alternate, as of the date of the sale.

ILLUSTRATION A
COMPARATIVE INTEREST RATES



STATEMENT OF CALVIN H. JOHNSON, PROFESSOR OF LAW, UNIVERSITY OF TEXAS LAW SCHOOL

The Tax Reform Act of 1984 added section 1274 to the Internal Revenue Code to impute interest on buyer liability given to a seller for property. Prior law treated such seller-financed sales so generously that the parties were effectively given a license to print money. The 1984 Act sought to prevent "mismatching of income and deductions by lenders and borrowers. . . . Such mismatching of income and deductions had severe revenue consequences, since the present value of the income included by the lender . . . was less than the present value of the deductions claimed by the borrower." [1]

This testimony will explain the abuse that was the target of the 1984 act and explain why the Act failed to prevent the most flagrant abuses it was intended to remedy. It and will recommend simpler and sharper remedies to end the abuse.

STATEMENT OF THE PROBLEM UNDER PRIOR LAW

Section 1274 of the Code was enacted in 1984 as a part of Congress' effort to make a $50,000,000,000 "downpayment" toward closing the budget deficit. Under prior law, seller-financed sales of property, especially real estate, benefitted from negative tax: Seller financed sales bore no tax themselves and in fact saved tax the parties would otherwise pay on income from other sources. The factor most responsible for the negative tax was an asset that I have called a "tax float." When Congress was looking for ways in which to close the deficit in 1984, it looked first to transactions that had a negative tax. It made sense to bring tax float transactions up to zero tax before increasing the real tax borne by others. That strategy remains a wise one today.

Tax float defined.

Before 1984, a tax float arose because the tax law commonly treated the two parties to some debts inconsistently. The obligor—the debtor of a two party debt—got immediate tax deductions as if unpaid debt were already paid. However, the obligee—the other party to the debt—was treated as if unpaid debt did not yet exist, that is, he did not pay tax on the debt until it is actually paid. The debt thus saved tax on one side before the concommitant tax had to be paid on the other. The parties therefore created and shared an asset at government expense, a "tax float," by creating two-party debt.

Assume to illustrate that a tax shelter investor under prior law owed $100,000 management fees to a cash method shelter promoter and that the parties were otherwise unrelated. Assume that the fee liability was to be paid 12 years after it became fixed and that both investor and promoter were in the same 50% bracket. If the investor incurred his obligation through an accrual method partnership, the investor was able to deduct the $100,000 liability when it become fixed and could save $50,000 tax 12 years before the cash method promoter received the fees and had to pay back $50,000 tax.

Under these assumptions, the parties to the debt, viewed as a partnership vis-a-vis the government, created a 12 year interest free loan from the government. They were richer by the value of the 12 year use of $50,000 than they would be had the debt not arisen. Alternatively stated, the parties succeeded in delaying the collection of $50,000 in taxes for 12 years and the government had to look elsewhere for its revenue.

ACRS debt

Big tax floats also arose under prior law when depreciable property was in exchange sold for the buyer's promise to pay for the property in the future. Under Crane a buyer's basis for depreciation and ITC included and still includes debt he gives the seller to purchase depreciable property. The present value of the depreciation and ITC benefits under ACRS is commonly at least as valuable as deducting the debt immediately.[2] Thus the ACRS debt was in economic effect deducted immediately just like an expense debt. In any event the buyer got tax savings which were earlier and more valuable than the tax the seller had to pay on the debt. Under the installment sale provisions of IRC § 453, the seller did not take the income from the debt into account until it was paid. Since both Crane and installment reporting were available to both cash and accrual taxpayers, the tax float occurred without regard to whether buyer or seller was on the cash or accrual method.[3]

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[1] Staff of the Joint Committee on Taxation, general explanation of the revenue provisions of the Tax Reform Act of 1984 at 110 (1984) [hereinafter staff explanation of the 1984 act].

[2] Calculation of the present value of the tax savings from ACRS property for various discount rates is found for instance in Johnson, Tax Shelter Gain: The Mismatch of Debt and Supply Side Depreciation, 61 Texas L. Rev. 1013, 1021–1025 (1983).

Tax floats under prior law were commonly more valuable than any nontax economic aspect of the tranaction. For instance, the present value of the use of $50,000 for 12 years is $34.068, assuming a 10% discount rate. The present value burden of a $100,000 debt payable in 12 years is only $31,863, using the same discount rate. Whatever the importance of the management fee to the parties in the hypothetical, it was less important than the tax float they had created.

Interest was no cure

Interest on the tax float debt, if any, affected how the value of the tax float was shared between the parties but it did not reduce the value of the underlying tax float on the principal of the debt. For instance, if we assume 10% interest was paid annually on he $100,000 debt, the obligee would pay $5,000 tax upon receipt of $10,000 interest. But the obligor saved $5,000 by reason of the interest. The extra tax paid to the government because of interest was completely offset by the extra tax saved because of deduction of the interest. The government did not receive any compensation from the interest and the interest did not reduce the value of the tax float. The parties still got $50,000 tax savings many years before the $50,000 had to be repaid. Interest was a transfer between the parties, but it is like the reallocation of partnership profits between partners which however did not change the value of the partnership asset.

Additional interest, in fact, often compounded the problem of tax floats when it was accrued interest that was deducted but not paid. If the obligor deducted the $10,000 interest when earned without paying it, there was a tax float of $5,000 added on top of the $50,000 tax float on the principal that started a year earlier. The added interest just increased the amount that was deducted before it is taxed.

Cash borrowing distinguished

Both cash loans and tax floats gave the debtor a deduction when he was only a liability, but a tax float debt is otherwise quite different from borrowing cash. For cash loans, the lender of the cash or some predecessor (like a depositor at a bank that made the loan) usually has to pay tax on the cash to have it to lend. Cash normally arises in our economy only post-tax. The cash borrower can then be viewed as stepping into the shoes of the lender and getting only a refund of his predecessor's tax--much as a donee steps into the shoes of a donor. Secondly, cash borrowed to pay for property goes immediately to the seller and causes the seller to pay immediately tax, notwithstanding the installment or cash method. The government thus recaptures at least part of the cash borrower's tax savings from the other party receiving payment. The tax the cash borrower saves, in sum, is usually more than made up by tax paid before or just after his borrowing. In tax floats, by contrast, the government captured no immediate tax from a recipient of cash because tax floats debts turn over no cash. Moreover the payee, who was the creditor of the tax float liability, had no tax position to give over to the payor, who was considered the borrower, other than the payee's basis in property sold. If any. Allowing the payor to step into the shoes of his creditor the payee usually gave the payor no justification for any deductions. In short, cash borrowing creates no "tax float" subsidy to the parties.

Cost-free debt

In the most virulent form of the tax float, the tax savings an obligor got from debt exceeded the cost of actually paying the debt. Thus the debt was cost-free or better after tax. As noted an interest free obligation of $100,000 payable in 12 years could be satisfied by setting aside $31,863 with a 10% discount rate. But the liability saved tax immediately of $50,000. In present value terms, the payor was better off with the debt, after tax, than he would have been if he had never incurred it.

Once the obligor of the debt has cost free debt, he wanted the debt to expand. The courts in general rely on private bargaining to produce reasonable results, but with cost free tax float debt both sides had inventives to create debt that was as large as could be justified. The larger the debt, the larger the pie to split. With cash borrowing the lender at least wants to hold down the debt; in tax floats the payee wants the debt to be as high as possible for the property or services he has provided. It is difficult to see why cost-free debt was not more common before 1984 than it was. As far as the parties were concerned the larger the debt, the better off they were. The management fees could be $10,000,000, as long as it could avoid audit. In a system where cost-free debt were readily available, it is difficult to see why anyone paid tax. The tax shelter industry had grown up to exploit the overrespect given taxpayer's liabilities and the industry should have been expected to exploit cost free liabilities to their fullest as long as they are available. An expense to be paid in the future, sufficiently large and deferred for a sufficient time, should have eliminated any tax due.

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[3] An exception to the tax float idea has to be made to reflect the seller's basis at the time of sale: The tax float advantage is that taxes are saved by the buyer before the seller pay tax. The seller's basis, however, sometimes represents tax that the seller has paid previously. Still tax floats are common on ACRS property in so far as the sale debt exceeds the seller's basis.

Without the inconsistency between treatment of the obligor and the obligee, cost-free debt would not have been possible. If an obligee were taxed when the liability was fixed, debts that were cost-free to the obligor would symmetrically have required the obligee to pay tax that is higher than confiscation in present value terms. Taxable obligees would not arrange such debt. But even tax floats short of the cancer of cost-free debts still did damage under prior law. There was more private debt in the economy than there would have been in absence of the tax floats. The tax burden fell disproportionately on industries that could not arrange tax floats or individuals who could not or did not. There were no efficiency gains in the arrangements and plausibly quite substantial efficiency losses. Bringing the negative tax in tax floats up to zero was a tempting goal when Congress was looking for additional revenue.

TAX REFORM ACT OF 1984

Imputed interest under section 1274

The Tax Reform Act of 1984, in new sections 1274 and 467 of the Code, extended what were known as the "original issue discount" rules under prior law to cover at least some tax floats. The original issue discount rules of prior law had imputed interest, using compound schedules, on cash loans to a corporate borrower. As extended by the 1984 Act, the original issue discount rules treat certain large deferred payment for rent and services (IRC § 467) or for property (§ 1274) as if they were a borrowing transaction. The principal of the borrowing transaction is the present value of the future outlays, computed using pre-tax fair market value interest. Fair market value interest is identified in nonabusive cases as 120% of the interest rate the federal government pays on borrowings of comparable terms unless the parties identify compound interest of at least 110% of the federal interest rate. * * * Only the present value principal computed using that interest is treated as an expenditure when the liability arises. If the liability pays a current business expense like rent or salary, the expenditure amount is deducted immediately. If the liability is to pay a capital expenditure, the principal becomes basis in some asset and is written off only over the tax life of the asset. The rest of the deferred payment is then treated as interest and it is deducted as earned under a compound interest schedule. Compound interest starts low in early years because the present value principal is relatively low, but the earned but unpaid interest is added to the principal upon which interest is computed. As unpaid interest builds up the principal, the interest in later years gets larger. A compound interest schedule starts slow and builds up (and under prior law taxpayers were taking immediate or very rapid deductions for what were really interest earned under slow rates), but the system still allows all of the expenditure to be deducted before any outlay needs to be made.

Assume to illustrate, that a taxpayer owes $1,000,000 in 15 years without interest and that imputed interest (120% of the comparable federal rate) is 10%. The present value of the payment assuming 10% over 15 years in only $239,392 and only that amount would be listed as an expenditure at the start. Deductible interest at 10% would be $23,939 at the end of a year. The interest would be added to $239,392 [1] principal for $263,331 principal at the end of year 1. At 10%, interest for year 2 would thus be $26,333. The principal and interest would grow so that in the last year, $90,909 interest would be earned, which make the unpaid amount of principal and interest at the end of year 15 be $1,000,000, which would then be paid.

Section 1274 as fully phased in will apply to sales of property in general only if more than $250,000 aggregate consideration is given, applies to farm land only if the sale price might be greater than $1,000,000, and does not apply at all to principal residences. The Tax Reform Act also enacted IRC § 467, which imposes the original issue discount system on rental agreements of over $250,000 aggregate rent and gives the Treasury authority to impose the system, prospectively only, on similar size payments for services. Section 1274 especially has proven extraordinarily unpopular. Opponents have used rather intense rhetoric about a taxpayer's Constitutional rights to noninterest loans. The compound interest rules are confusing enough at least before you get used to them that they alienated and frustrated the tax professionals. Three months after the Tax Reform Act, Congress delayed the effective date and gave transitional relief to transactions before July of 1985.[2] These hearings today reflect the pressure for additional relief or repeal of the rules even before July 1985.

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[1] $\$100{,}000/(1.1)^{15} = \$239{,}392$.

The inadequacy of section 1274

The original issue discount rules enacted in 1984, for all their unpopularity, are too lax not too strict. The problem with prior law was tax floats coupled and cost free liabilities. Section 1274 for all of its complexity does not solve those problems. The payor of an obligation used to acquire property is still getting a deduction for amounts to be paid in the future many years before he pays the liability and well before the other side to the transaction must include the liability in income. Section 1274 incidentally puts the seller on the accrual method with respect to interest and thus ends the tax float with respect to the imputed interest element, but the principal or present value amount still creates basis or a current expense to the payor and can be deducted on a better than expensing schedule many years before the liability is paid and taxable to the payee.

The original issue discount rules under prior law applied to cash borrowed by a corporation. In extending those rules section 1274 is treating a liability owed by the buyer as if it were a cash loan from the seller. In fact, however, the debts section 1274 is governing are tax float debts and as noted a tax float debt is a quite different animal from borrowing cash. For cash loans, the borrower can be viewed as stepping into the shoes of the lender and getting only a refund of his tax his predecessor paid on the cash (much as a donee steps into the shoes of his donor). In tax floats, by contrast, the seller, who is the creditor of the liability, commonly has no tax position to give over to the payor. Cash borrowed to pay for property goes immediately to the recipient and causes immediate tax, notwithstanding the installment or cash method. In tax floats the seller or payee can defer tax. In cash loans the tax the cash borrower saves is usually more than made up by tax paid before or just after his borrowing. Cash borrowing does not create an asset vis-a-vis the government, while a tax float does.

Moreover section 1274 allows liabilities to be tax free after tax. The interest rate that has to be imputed on liabilities, in order to prevent the tax savings from the liability from exceeding the detriment of paying the liability by the time the liability has to be paid, is considerably higher than the interest rate imputed by section 1274. For example using current conditions, 120% of the federal rate is 14%, but safe after-tax discount rates, as indicated by the going municipal bond rates, are at least 10% even to a 50% bracket taxpayer. Given those rates, a 50% bracket taxpayer gets more value from his tax savings from deducting present value principal given for 18 year real property and interest as earned than the value he has to pay on the liability if the payment of the liability occurs more than 19.19 years after the sale occurs.[1]

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[2] Pub. L. 98-369 (October 31, 1984).

[1] 19.19 is the value for n that satisfies the following formula.

$$1=(D_{pv})(T)\frac{(1+d)^n}{(1+i)^n}+Ti\left[\frac{(1+i)^n-(1+d)^n}{(1+i)^n(i-d)}\right]$$

where D_{pv} is the present value of depreciation deductions using after tax discount rate d (10%), T is tax rate (50%) and i is the interest rate used to impute interest (14%). The 1 is $1 of outlay n years in the future, the first term in the equality to 1 is the terminal value of depreciation deductions on the present value principal computed under accounting discounting. The second term is the terminal value of deducting compound interest as earned. The calculation of D_{pv} here (.5227) at 10% assumed 18 year 175% declining balance depreciation with no mid month convention. Lower rates for d will increase D_{pv}.

Cost free liabilities are still available after 1984. To ensure that liabilities are not cost free to a 50% bracket taxpayer, when discount rates are 10%, the imputed interest rate must be 20%.[1]

Finally, given the seriousness of the tax float and cost free abuse under prior law, the exemptions in 1984 seem unduly generous. It does not seem appropriate to allow taxpayers to print money, for instance, as the tax float transaction allows, just because they print the money in runs of less than $250,000 each.

Other 1984 act provisions

Several other provisions enacted in 1984 after tax floats and cost free liabilities without seriously impeding the ability of any group of taxpayers to take advantage of the abuse. Section 267(a)(2) of the Code (amended by the Tax Reform Act § 174) now prevents an accrual method payor from deducting liabilities owed to a related party (defined by section 267(b)) who is on the cash method before the related party is paid:

"Congress believed that persons who are related should be required to use the same accounting method with respect to transactions between themselves in order to prevent the allowance of a deduction without the corresponding inclusions in income."[2]

Prior law had allowed a 2½ months grace period within which the accrual payor could pay the expense and still get the deduction in the year before paid. Section 267(a)(2) prevents the tax float abuse between related parties but it does not encorporate the perception that even unrelated parties will act as partners against the government to create a tax float asset which they can then share. The Tax Reform Act also allowed an anomolous exception to the section 267(a)(2) rules to allow tax floats with respect to depreciable property. Section 267(a)(2) says it takes away only those deductions that depend on the taxpayer's method of accounting:

"It does not apply, for example, to expenses such as the deductions for cost recovery or depreciation deductions [where basis including debt does depend upon the taxpayer being on the accrual method]."[3]

Thus tax floats can be constructed, out of the inconsistency between Crane basis and installment sales, even between related parties.

The Tax Reform Act enacted a number of other provisions affecting expense accruals but not tax floats with respect to property. The Act expanded section 404(a)(5) of Code, which had previously required an employer to wait until his employee includes deferred compensation in income before deducting the compensation. Prior law cases had construed "deferred compensation" very narrowly and the Act broadened matching to include "benefits (other than deferred compensation)." The Act § 512 (amending IRC § 404(c)) expanded that matching requirement to include, for example, a "limited partnership that uses the accrual method of accounting for compensation owed to cash-method taxpayers, who perform services for the partnership."[4] Section 404(a)(5) is being narrowly interpreted by the Bar even after amendment as not applying where services are just a mixed part of a contract package and where the liability generates a capital expenditure. Section 404(a)(5), in any event, clearly applies only to accruals for services. The economic performance rules of new subsection 461(h) also have some effect on tax floats with regard to expenses. Subdivision 461(h)(2)(C) prevents deduction of tort and workman's compensation claims before payment of the claims and that prevents tax floats and cost free liabilities, but only as to tort and workman's compensation. Subdivisions 461(h)(2)(A)&(B) deny accrual deductions unless the underlying services or goods are provided within 8½ months of the close of the taxable year of accrual, but the subdivisions do not prevent tax floats created for past or current services or goods or for services or goods provided within the quite generous grace period.

The Tax Reform Act §112(a), enacting new subsection 453(i) of the Code, attacked tax floats on depreciable property by requiring a seller of depreciable property to "recapture" amounts immediately upon an installment sale of depreciation property. Prior law allowed the seller to wait until installments were actually paid by the buyer before recapturing prior depreciation. "Recapture" in general means that prior depreciation deductions become ordinary income instead of capital gain to the taxpayer if the sale price is large enough. IRC §§1245, 1250. New subsection 453(i) requires the seller to pay immediate tax recapture amount computed as if all payments to be received were received in the taxable year of sale. For equipment, all previous depreciation can be recaptured if the sale price is high enough, but for real property, recapture is relatively weak. Only "excessive depreciation," defined as that in excess of straight line amounts, is recaptured and that is commonly only a small fraction of the depreciation taken. Tax floats are still possible on depreciable property recapture is so weak.

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[1] In general the imputed interest rate must be d/1-T, where d is the best after tax discount rate available to the taxpayer and T is the taxpayer's tax rate. Only that rate will prevent the right side of the equation in the last note from exceeding the $1 cost as n reaches very large numbers.

[2] Staff explanation of the 1984 act at 542.

[3] Id.

[4] Id. at 805.

The patchwork of remedies in the 1984 Act, in sum, are useful and correctly limit tax floats, but the patchwork is not sufficient to abolish the tax float abuse nor to hold onto the revenue that the abuse costs.

ADEQUATE CORRECTION OF THE TAX FLOAT ABUSE

Ending advance credit

A tax float can be defeated by imposing consistency on either side. The obligee, for instance, could be required to recognize income upon creation of the debt, notwithstanding the cash or installment methods, if his obligor is getting credit for the debt. The 1984 Act does require a payee to pay tax on some unpaid liabilities.[1] It seems better theory, however, to deny the obligor deductions with respect to unpaid tax float debts. Prior law treated debts as good as gold—as if they were already cash paid. Treating debts as if they were already expenditures is a vestige of nineteenth century accounting that was blind to the time value of money. The payment is the economic burden of the liability; the debt is at best a reflection of the future burden. The assumption that bargaining will create debts that have a detriment equal to payments of cash does not hold for tax floats. Giving the taxpayer advance credit for future payments misdescribes the taxpayer's position.

Fixing the tax float on the payor's side seems especially forced if Congress continues the Accelerated Cost Recovery System ("ACRS") or something like it. As explained elsewhere, even cash borrowing will generate negative taxes under ACRS.[2] Depreciable property purchased for its fair market value with debt will always generate artificial tax losses. As then Secretary Regan testified when ACRS was enacted in 1981, such negative taxes are an "unintended result." ACRS implies that the correction of the tax float should be to deny the advance credit given to debt.

Congress, accordingly, should stop treating liabilities to pay in the future as if they were already expenditures. Congress should define cost, within the meaning of section 1012 of the Code and for the purpose of computing depreciation, as including only cash paid for the property. Cash cost within the meaning of the new section 1012 would include cash borrowed to pay for the property and paid over to the seller by the end of the year.

The cash borrowing election

At some sacrifice in simplicity, the buyer and seller might be allowed to treat a tax float debt as if the parties had used cash instead. In a tax world in which cash loans but not tax flats were included in the buyer's basis, a seller could give his buyer basis at the same tax detriment to himself that he has in borrowed cash. If a seller were willing to finance his buyer's cost, it would be possible for the seller to borrow cash from a bank or other third party, lend the cash to the buyer, receive the cash back as taxable purchase price of the property sold and repay the cash loan to the bank—all on the same day. That transaction would satisfy the policy concerns about the tax shelter abuse—if the seller was taxable and in the same tax bracket as the buyer. The seller would be making his investment in the liability out of post-tax money and the government would be recapturing at least some of the tax revenue lost to the buyer from out of the seller's hands. The quick borrowing and repayment by the seller would not fill the seller's credit limit for very long. If the law required the parties to go through a real borrowing of cash, the major consequence would to cause the parties to bear the transaction costs of a quick borrowing and repayment. If law would allow the seller and the buyer to elect jointly to treat the sale for debt as if it were a sale for cash, then the law would avoid wasteful transaction costs to society without losing any revenue that it would otherwise get. It should be possible to add administrative requirements to the election so to make enforcement of consistency relatively easy. The election would mean that the seller would pay tax on the debt, as if it were paid, notwithstanding an installment election or cash methods of accounting.

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[1] For instance, section 453(i) (recapture in installment sales); section 1274 (interest on large sales of property); section 467 (rent and interest on large rental transactions); section 467(g) (interest on large service transactions).

[2] Johnson "Tax Shelter Gain: The Mismatch of Debt and Supply Side Depreciation" 61 Texas Law Review 1013 (1983).

Such an efficient mechanism, equivalent to cash borrowing for tax purposes, may invite too aggressive an intervention in the credit market by nontaxable entities. It would preserve no revenue if all payees making the new election were tax exempt. Current shelters often use pension funds sandwiched into a transaction to turn onerous accural of income into harmless accruals. A pension fund, for instance, might be paid a fee or commission to buy depreciable property and resell it immediately to high bracket investors who would make an election to treat their debt as cash borrowing. The pension fund would agree to treat the sales price owed to it as if the debt were cash, without any tax detriment, just to give the high bracket investors the benefit of a cash borrowing election on what is really a tax float. Pension funds, accordingly, might have to be taxed on income from sales of property just as a taxable entity would if the parties make an election to treat a tax float as if it were a cash payment. The pension fund's basis would include cash paid for the property but not tax float debt it has paid. Prior precedents for taxing tax-exempt entities when they enter tax driven commercial transactions include the "unrelated trade or business rules" and especially the unrelated debt-financed income provisions of section 514.

Treatment of outlays on liabilities for depreciable property

Treating only cash payments and not promises to pay as expenditures raises the question as to how to treat cash outlays made to pay a tax float debt. Where a tax float liability pays an expense, the liability would be deducted as soon as it is treated as an expenditure, that is, as soon as it is paid. Where a tax float liability pays for depreciable property, however, the buyer can not always be allowed a deduction as soon as the liability becomes an expenditure because that would be inconsistent with appropriate capitalization and depreciation policy.

In an income tax, costs of property are capitalized rather than deducted immediately because they are investments or savings that are appropriately part of the base subject to tax. The expenditures of cash for property are not losses of value appropriately treated as deductions: "In theory, the taxpayer has not actually spent the dollars he paid for . . . an asset but rather converted them into a different type of property."[1] Investments are normally post-tax in an income tax. The advantage of making investments with pre-tax or tax deductible money—"soft money"—is as valuable to an investor as not having to pay tax on the subsequent income from the investment.[2] Giving taxpayers the soft money privilege for some investments badly distorts investment decisions. If the taxpayer could deduct all outlays made under a tax float debt, then buyers could avoid capitalization simply by purchasing an asset for a liability to be paid in a short time such as a year. Buyers would then deduct the cost of the asset after a year rather than over its tax life. A one-year deferred deduction of the cash for an asset would not be the same as exemption for all the income from the property, but it would be equivalent to an exemption for the income that comes after the deduction.

In a true income tax, the expenditures are allowed as a deduction only as the property declines in value; only as the property declines in value do the expenditures expire and represent a deductible decline in ability to pay tax.[3] Deduction of the cost of property that has lost value is perfectly consistent with the theorem that deductible investments give a privilege as valuable as tax exemption for the subsequent income. Once the costs have become worthless there is no subsequent income and exemption of nonexistent income gives no special benefit.

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[1] Kahn, "Accelerated Depreciation—Tax Expenditure of Proper Allowance for Measuring Net Income," 78 Mich. L. Rev. 1, 13 (1979).

[2] The pioneering articulation was made in Brown, "Business-Income Taxation and Investment" incentives, in Income, Employment and Public Policy; Essays in Honor of Alvin H. Hansen (1948). See also Andrews, "A Consumption Type or Cash Flow Personal Income Tax," 87 Harv. L. Rev. 1113, 1123, 1136 (1974). For expensing to be equivalent to exemption of subsequent income, tax savings incurred by expensing must be invested in the property, and the tax rate used to computed tax saved by expensing must be the same as the rate used to computed tax saved by exemption. One way of looking at the value of soft money or expensing is that a taxpayer who expenses the cost of property uses the government as a "fair partner" who funds a fraction of the investment, determined by the tax rate of the deduction. If the "fair partner" funds the investment at the same rate that he takes profits out (through tax), the fair partner has not reduced the rate of profit the investor can acheive. With both expensing and exemption, taxes do not reduce the investor's profit.

[3] Samuelson, "Tax Deductibility of Economic Depreciation to Insure Invariant Valuations," 72 J. OF POL. ECON. 604 (1964) proves that depreciation deductions which exceed declines in real value make property more valuable to high bracket than to low bracket taxpayers.

The appropriate test of whether an outlay on a liability can be deduced when made is whether the outlay has expired when made. The outlay has expired if adjusted basis is otherwise adequate, but has not expired if adjusted basis would then be too low. In a system basing depreciation on fair market value, the buyer's outlay for property would be added to basis to bring adjusted basis up to fair market value if necessary, but the outlay would be deducted immediately if adjusted basis is otherwise as large as the fair market value as depreciated. All costs not generating future income would be thus deducted, but all investments generating future income would then be post-tax investments.

Even under depreciation systems more generous than declines in value, not all outlays on liabilities can be made deductible. ACRS for instance requires costs of real property to be deducted over the 18 years. If outlays before 18 years pursuant to a tax float liability were deductible, then taxpayers would avoid the longer schedule by buying for tax float debt of less than 18 years and immediately deducting the payments of the debt. Under a system of fast depreciation, a taxpayer should still be required to keep an adjusted basis (the "post-tax amount") in the property equal to what other purchasers would have to keep—just purchasers in a fair market value depreciation system are required to keep adjusted basis equal to fair market value. Assume for example a 5 year asset purchased in 1985 for $100,000 borrowed cash and eligible for ACRS. The ACRS schedule allows deductions of 15%, 22%, and then three years of 21%, so that buyer for cash would have an adjusted basis of $85,000 then $63,000, then $42,000, $21,000 and 0 respectively at the end of the each of the five years of the tax life.[4] A buyer for debt should be treated the same. If he buys property for $60,000 cash and a $40,000 tax float debt, then he would get no deduction in year 1, because he does not have $85,000 post-tax cash (adjusted basis) in the property, he would get no deduction in year 2 because he does not have $63,000 adjusted basis in the property, but he would get an $18,000 deduction in year 3 to bring down his post-cash invested to $42,000. If he pays off the $40,000 tax float debt in full in year 4, he would deduct $29,000 in year 4 to bring down his post-tax cash investment to $21,000. Any cash payment that was made after year 5 would be deductible immediately. The sufficiency of a buyer's adjusted basis, in sum, would be tested by comparing his basis to a phantom section 168 schedule starting with the cash price or fair market value as the original basis. The system would prevent tax floats from giving advantage over purchases with cash or cash borrowing, while allowng the purchaser to deduct those costs that are considered expired under the given depreciation schedule.

CONCLUSION

Prior law before 1984 treated a promise to pay in the future as if it were as good as a cash payment. The system allowed parties to debt to create an asset, called a tax float. A tax float is an anti-revenue whipsaw in which the parties to debt are treated inconsistently—though the debt has only a single reality. The inconsistency created wealth, at the expense of the tax system, where no economic substance resides.

Section 1274 of the Code, enacted in 1984, attacked tax floats but it misanalyzed tax float debt as if it were cash borrowing. Interest imputation under section 1274 is not a sufficient remedy to prevent the abuses of tax float debt and of cost free liabilities freely available under prior law. Opponents seeking repeal or liberalization of section 1274, however, are seeking to return to the the strong negative tax, to the full unfettered tax float available under prior law. Opponents of section 1274 are seeking to renew their license to print money. Given the deficit, Congress can not afford the negative tax that arises from identifiable anomalies including, quite prominently, tax floats.

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[4] Section 168(b)(1). The hypothetical assumes that the taxpayer reduced investment credit by 2% instead of reducing adjusted basis by half of the depreciation taken. Section 48(q)(4).

STATEMENT OF HON. ROBERT T. MATSUI, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF CALIFORNIA

Mr. Chairman, and members of the committee. I have introduced legislation, H.R. 2069, which offers a permanent solution to the imputed interest controversy that has been the subject of intense public debate since the 1984 Tax Reform Act was passed. The stopgap corrective legislation which Congress enacted last year expires July 1 and I would like to urge my colleagues to join me in an effort to resolve this issue.

The distinguished Chairman of the Ways and Means Committee, Mr. Rostenkowski, promised the Congress last June that he would address the imputed interest issue before the transition expired. My good friend from Illinois is fulfilling that promise by scheduling this hearing today on this issue and I applaud the Chairman for this action as it would be devastating to let the transition rules expire without creating a workable solution.

As my colleagues are aware, the Deficit Reduction Act contained provisions that threaten to substantially disrupt, if not stop entirely, legitimate and economically motivated real estate transactions. This threat is contained in a law that increases the required interest rate for seller financed real property transactions from 9 percent to a significantly higher figure of 110 percent of the Federal borrowing rate for similar maturities. This means that a seller financing a sale of real property for 10 years must charge the buyer 110 percent of the rate which the Federal Government pays on 10-year obligations. Should the seller fail to charge an interest rate of at least this amount, the imputed interest provisions will impute a rate of 120 percent of the Federal rate to the seller for tax purposes. This, I contend, imposes a counterproductive, chilling effect on the real estate market.

For example, last summer the long term Federal borrowing rate was 13 percent—meaning that an owner financing the sale of property would have been required to charge at least 14.3 percent interest. This would create an impediment to many real estate transactions. The higher the conventional market interest rates, the more serious the chilling effect becomes because it is during high interest rate periods that seller financing is most needed.

Industry representatives have informed me that seller financing affects $30 billion of rental, residential, commercial, and industrial sales. These sales contribute $6 billion to the gross national product and represents 120,000 full-time jobs and about $2 billion in Federal, State, and local tax revenue. It is imperative that an acceptable solution to the imputed interest be reached so as not to put these sales in jeopardy.

The legislation I have introduced contains such a solution. My bill, H.R. 2069, will change the safe harbor and imputed interest rates so that they more adequately and reasonably reflect the current states of interest rates for real estate. This bill provides that for seller financing amounts below $4 million, the lower of 9 percent interest or 80 percent of the applicable Federal rate would be the test rate. If this rate is not met, the lower of 10 percent interest or 90 percent of the Federal rate will be imputed. For seller finance amounts in excess of $4 million, a safe harbor rate of 80 percent of the Federal rate and an imputed rate of 90 percent of the Fedoral rate will apply.

The importance of this 80 percent test rate particularly comes into play if interest rates rise again to the 15 to 17 percent levels. If interest rates get that high, seller financing becomes the only way that a seller can find a buyer for his property. The primary motivation is not tax avoidance, but simply a need for individuals to avoid a price for money which is for all but the richest too expensive.

My bill also solves the mismatching of income and deductions problem between buyer and seller that Treasury expressed such concern about last year. Under the provisions of my legislation, seller financed transactions below $4 million will be exempt from the original issue discount provisions in the act. Instead, both the seller and purchaser must agree to report the transaction for income tax purposes under the same method of accounting; that is, either the cash or the accrued method.

Furthermore, this bill will clarify the uncertainty of the status of assumed loans and wraparound loans with regard to original issue discount and imputed interest. Assumed loan amounts below $4 million will be exempt from OID and imputed interest provisions. Also exempted is the net amount of a wraparound mortgage below $4 million except for the amount of any pre-existing underlying obligation. In determining whether the 9 percent or 80 percent safe harbor rate is met, the interest rate of the seller's wraparound mortgage and the net cash flow from the prior obligation will be considered.

A solution to the imputed interest issue should not focus primarily on preventing a perceived tax abuse as the drafters of the present imputed interest provisions have done. Seller financing is not a tool used to facilitate tax abuse. It is a means of structuring a real estate transaction so that it is affordable to potential buyers. The American public does not need government interjecting itself into the reasonable and customary real estate transactions that occur daily. The American public needs flexibility and certainty to conduct its business. The solution I propose to the imputed interest issue will provide the measure of flexibility that the real estate industry needs. This approach is simple, straightforward and allows for an orderly real estate market in any interest rate scenario.

I recognize that during the coming weeks, revisions to this approach may be necessary. I am certainly open to improvements regarding all aspects of the legislation and plan to work closely with my colleagues on the committee and the staff to obtain the most reasonable and responsible legislative package.

I urge my colleagues to support this legislation.

QUARLES & BRADY,
Milwaukee, WI, April 5, 1985.

Mr. JOSEPH K. DOWLEY,
Chief Counsel, Committee on Ways and Means, House of Representatives, Longworth House Office Building, Washington, DC.

DEAR MR. DOWLEY: This law firm has approximately 140 lawyers, and about 15 percent of them are involved in tax matters on a regular basis. The undersigned is in charge of the Tax Group. Collectively, we have spent hundreds of hours both in firm sessions and out learning the current imputed interest and discount rules. Some of us have mastered them, some of us have not. In any event, it is safe to say that the current system is overly complicated and poses nearly dozens of traps for the unwary.

Clients of ours are buying and selling businesses, real estate, etc. on installment basis. They are also buying and issuing debt instruments. These clients have no theoretical objection to the imputed interest concept. It is just that they have a hard time understanding the rules, and we have an even harder time explaining them to our clients.

When a firm as sophisticated as ours in tax matters struggles with these issues, one wonders how small accounting firms and law firms throughout the United States can cope with the problems. Our clients want to obey the law and stay within the framework. The problem is the law, as it now stands, is virtually incomprehensible.

We urge that Congress adopt a rather simple and consistent policy of imputing interest, one without many exceptions and exceptions to the exceptions. Equally confusing is the constantly changing interest rate made worse by applying to different debt instruments depending on their number of years to maturity. We suggest imputing at 9, 10 or 12 percent per annum and be done with it. If the rates get substantially out of line, give the Treasury the power to change the rate but require that it be done on a calendar year basis using a whole number and consistently applied to all debt instruments regardless of the term to maturity.

The administrative headaches and the costs to the business community are not worth the excessive fine tuning of the current legislation. So what if some taxpayers get away with some benefit on the interest spread. Current law and anything even close to it is just too sophisticated for the normal business community. When the bill was pessed, I doubt there was one congressman who really understood what an actual mess was being passed. Today there may be one or two, but they must have strong stomachs as well as minds to understand the problem.

The new imputed interest rules make the automobile substantiation requirements look like duck soup. Unfortunately, the vast majority of the business community is not aware of what a mess there is lurking every time they enter into some relatively simple business transactions.

Respectfully submitted.

JOHN A. HAZELWOOD.

STATEMENT OF THE SACRAMENTO CALIFORNIA BOARD OF REALTORS

This statement is submitted by the Sacramento Board of Realtors, a trade organization representing over 3,000 real estate licensees. We commend the Chairman for holding these hearings and for providing an opportunity to discuss permanent imputed interest/seller financing tax rules.

The imputed interest provisions contained in the Deficit Reduction Act of 1984 have been the subject of intense controversy since their enactment. The Deficit Reduction Act contained substantial changes affecting the taxation of seller-financed real estate transactions.

Without the adoption of permanent corrective legislation, the imputed interest rules passed by Congress in 1984 will become effective in July, and will:

force sellers to establish interest rates that reduce housing affordability and significantly impact transaction volumes

adversely affect the provision of rental housing and have an upward impact on residential rents

reduce investment in commercial/industrial real property and reduce economic growth

penalize those transactions accomplished by means of more affordable non-insitutional financing (including wrap-around and related instruments)

We congratulate members of this Committee and others in Congress for providing helpful legislation to mitigate the impact which would have resulted to the real estate industry, and to the overall economy, had these rules been allowed to totally take effect as originally scheduled January 1, 1985. However, the stopgap legislation enacted late last year which maintained reasonable interest rate rules for many seller financed real estate transactions expires July 1, 1985 and we urge Congress to promptly address this issue.

RECOMMENDATION

The Sacramento Board of Realtors, in conjunction with our state and National Association, does not ask that the clock be totally turned back to the pre-Deficit Reduction Act seller financing rules. We believe that the revenue problems which brought about these rules can be legislatively addressed without paralyzing seller financed real estate transactions.

More precisely, Realtors strongly support the legislative solution to the imputed interest issue contained in H.R. 2069 introduced by Representative Bob Matsui of Sacramento (and S. 729 authored by Senator Dave Durenberger). This solution would ensure the continued availability of seller financing at reasonable interest rates in all economic environments.

The Matsui legislation will accomplish the following:

On amounts of seller financing up to $4 million per transaction, the test interest rate shall be either 9 percent or 80 percent of the AFR, whichever is lower. Further, in the event that the test interest rate is not met, the imputed interest rate shall be either 10 percent or 90 percent of the AFR, whichever is lower.

On amounts of seller financing in excess of $4 million per transaction, the test interest rate shall be 80 percent of the AFR and the imputed interest rate shall be 90 percent of the AFR.

The Imputed Interest and Original Issue Discount rules will not apply to assumptions of loans or to loans taken "subject to", regardless of when the loan was originated.

In Wraparound Financing, Contracts for Sale, Contracts for Deed or similar all-inclusive debt instruments, the imputed interest and original issue discount rules will apply only to that portion of the debt taken back by the seller exclusive of any underlying debt. The test interest rate shall be measured against the actual rate of return on the seller's equity.

Transactions below $4 million of seller financing shall be excluded from the original issue discount provisions. However, buyer and seller will be treated as being on a cash/cash accounting method unless they agree to account for the transaction on an accrual/accrual method.

Transactions of more than $4 million of seller financing shall be subject to the original issue discount rules.

In our community and throughout the country, the ability and willingness of owners to finance sales of residences, farms, multifamily dwellings and businesses at affordable interest rates charged by third party institutional lenders. This is especially true during high or rising interest rate periods. For example, during the high interest rate recession of 1982, the great majority of home sales in our area relied on seller financing at interest rates between 10 and 12 percent. Seller financing was an equally important financing mechanism for commercial office buildings and multiple structures.

Against this background, it is our view that this measure will ensure a level of activity sufficient to promote increased revenues to the Treasury, yet will effectively address transactions involving major revenue losses.

We urge Congress to adopt a solution substantially similar to that contained in H.R. 2069 by Congressman Matsui. Further, we would suggest that this legislation be adopted as soon as practical (and before July 1, 1985) to ensure that real estate markets can function effectively and that significant economic disruption is avoided.

We appreciate the opportunity to submit these comments.

STATEMENT OF THE UNITED STATES LEAGUE OF SAVINGS INSTITUTIONS

INTRODUCTION

The U.S. League of Savings Institutions[1] would like to alert the Ways and Means Committee to a number of serious problems resulting from passage of the Deficit Reduction Act of 1984 (P.L. 98-369) and its extension of original issue discount (OID) rules for the first time to the standard residential mortgage transaction. The U.S. League appreciates the need for the tax code to address the issue of the appropriate timing of interest income and expense in an attempt to deal with potentially abusive transactions and recognizes that the OID concept is theoretically the answer to such problems. Our concern, however, is that an unintentional cloud has been placed over normal and non-abusive features of the common residential mortgage transaction and we would appreciate a clarification of the intent of Congress in this area. Last year's Deficit Reduction Act includes a section, 1275(d), which grants the Treasury-wide latitude in implementing regulations for extending OID coverage to residential mortgages. We have already raised a number of our concerns with Treasury staff who indicate, and properly so, that they must follow the statutory direction provided in the law. It appears to be Treasury's interpretation and it certainly is our belief that the Deficit Reduction Act will force recognition of OID in almost every mortgage originated subsequent to March 1984, resulting in costly, complex OID calculations for every mortgage lender—since almost all mortgages have some minimal OID.

Our concerns are not directed at Section 1274 which deals with the issuance of debt instruments for property. Our understanding of the intent of this Section is that it is designed to deal with potential abuses in seller financing whereby losses from concessionary nominal interest rates on loans are recaptured via inflated sales prices, thereby converting tax-heavy interest income into tax-light capital gains. The standard role of our member savings institutions is as a third party financier in a residential real estate transaction providing the financing for a homebuyer to pay a home seller and where all the parties involved are dealing at arm's length and at market prices and interest rates. Because we believe it was certainly not Congress' intent to apply the complicated and costly OID calculations to every standard mortgage transaction, the U.S. League recommends that Congress completely exempt third party arm's length residential mortgage transactions from OID as was the case prior to last year's tax act, or if included, that standard mortgage transactions charging five (5) or six (6) points be established legislatively as an adequate safe harbor for de minimis OID.

The 1984 Deficit Reduction Act in addition to extending the OID rules to mortgages also required lenders to report mortgage interest received to its borrowers and the IRS. Therefore, future OID on mortgages will now be required to be calculated and reported on information returns to borrowers over the full term of the mortgage beginning in tax year 1985.

The complexity of OID rules, if applied to standard mortgage transactions, will make it very difficult for lenders to gear up for this requirement in time. In addition, there is a discrepancy between the onset of the applicability of the OID regulations. March 1984, and the tax year which must be covered in the first information return, January through December 1985. Though lenders already routinely a report to each customer indicating the total interest expense on the loan for the year based on a normal loan amortization calculation, this calculation is by no means sufficient to meet the complexities of the OID rules.

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[1] The U.S. League of Savings Institutions serves the more than 3,400 member institutions which make up the $1.1 trillion savings association and savings bank businesses. League membership includes all types of institutions—federal—and state-chartered, stock and mutual. The principal officers include: John B. Zellars, Chairman, Atlanta, Georgia; Gerald J. Levy, Vice Chairman, Milwaukee, Wisconsin; William B. O'Connell, President, Chicago, Illinois; Philip Gasteyer, Executive Director of Washington Operations and Senior Vice President; and James O. Freeman, Senior Vice President and Senior Legislative Representative. League headquarters are at 111 East Wacker Drive, Chicago, Illinois 60601. The Washington office is located at 1709 New York Avenue, N.W., Washington, D.C. 20006. Telephone: (202) 637-8900.

At a minimum, the application of the OID rules to mortgage finance would require substantial additional handling of every mortgage, either manually or by an automated system. OID calculations are so complex, lenders would need a sophisticated computer system just to make the computations. After initial OID calculations are done at origination, additional complex and costly calculations would be necessary to make adjustments which typically would amount to $10 on a $10,000 annual interest expense for a loan in its first year. A lender making mortgages which have OID and holding such mortgages in its portfolio would be required to account for OID and include it as income each year.

As a result, lenders will have to slow down their mortgage processing, costing them both time and processing fees for each mortgage. And because few lenders now have the in-house system capability or personnel to properly account for OID, lenders may need to hire costly consultants to help them meet the OID requirements.

Our institutions deeply sympathize with the goal of the Treasury and the Congress to eliminate costly abuses of the tax system. However, we also are concerned that when we eliminate the abuses we avoid the unintentional entanglement of the standard mortgage transaction in the complex rules required to address the intricate tax shelter problems.

APPLICATION OF OID PRINCIPLES TO "POINTS" CHARGED IN HOME MORTGAGE TRANSACTIONS

Over time, a well-understood set of procedures for dealing with the associated tax issues in these regular mortgage transactions has evolved. With the reporting changes made by the 1984 law, and the extension of OID coverage to obligations of natural persons and holders of obligations not constituting capital assets (for those holders), it is unclear how these procedures fit into the new OID framework. The first question which arises is the appropriate treatment of fees charged at the origination of the mortgage such as points and odd-days interest, hereinafter jointly referred to as simply fees or points.

Under previous law and regulation, the treatment of these amounts by both borrower and lender depended solely on whether the points were paid in cash at the time of the loan closing or whether the lender financed the payment of the points by the borrower who thus paid them in cash over the life of the loan. Where the borrower paid the points in cash at the loan origination, the borrower was entitled to deduct those points immediately in the tax year of the loan origination provided that the amount of such points was usual and customary in equivalent transactions in that real estate market area. Symmetrically in such cases, the lender would include those dollars immediately in taxable income for that year.

In the more common situation today, the lender finances the points, and does not include such dollars in income immediately, but accrues those fees into taxable income using what are known as the liquidation or composite methods. Equivalently in such cases the borrower is not entitled to an immediate deduction but has to defer the expense over the life of the loan.

If points are included in OID, the present system would no longer apply. The net effect of the complex OID rules is to place both borrower and lender (who normally are both cash basis taxpayers) on an accrual basis. In that event, even a borrower who paid the points in cash at loan closing would not necessarily be allowed an immediate deduction since the lower net proceeds of the loan transaction could be considered the equivalent of a corporation issuing a bond at a discount: therefore, deferral of expense could theoretically be required. Since separate sections of the tax code are in conflict, some resolution is necessary.

Even where the traditional approach mandated the amortization of points financed by the lender, the new OID treatment would require a burdensome change. The liquidation or composite methods now in use permit a measurement of the amount of points income to be recognized by the lender based on a simple analysis of the entire loan portfolio. Such helpful aggregation would be replaced by more complex loan-by-loan calculations under strict application of OID. An example of this complex OID determination and calculation is set forth in the attachment.

It is by no means clear that Congress intended such changes. It isn't even certain whether such changes are always necessary. Some readers of the code have argued that the impact of 1273(a)(2), the definition of stated redemption price at maturity, deals with the financed points in mortgage transactions since their inclusion into income and expense would be deemed concurrent with every payment on the loan—since each payment includes a component of return of loan principal and payments are made more frequently than annually, the standard in 1273(a)(2). However, 1273(a)(2) also includes a segregation of loans with fixed interest rates from those with variable interest rates. That could pose a problem, too, in that adjustable rate loans now play a significant role in residential mortgage finance, and indeed, were the dominant form of mortgage originated by savings institutions in 1984.

NEED FOR ADEQUATE SAFE HARBOR FOR POINTS ON REAL ESTATE LOANS

Unfortunately, it remains unclear whether the de minimis rule of 1273(a)(3) will provide an adequate "safe harbor" for the standard mortgage transaction. This 1273(a)(3) safe harbor exempts from OID application obligations where the discount is less than ¼% of the redemption price times the number of years to maturity. For a 30 year mortgage loan, the simplest calculation would be to take the ¼% times 30 years to give a safe harbor points limit of 7.5. Such a safe harbor would be adequate and would certainly exempt regular transactions from the complexity of OID computations.

However, it could conceivably be argued that since mortgages do amortize, it is not appropriate to apply the de minimis rule quite so mechanically because not all of the principal balance is outstanding at all times. Adjusting for this phenomenon adds complexity to the safe harbor calculation since at different interest rates, mortgage loans of a given maturity pay off at slightly different speeds. For a $100,000, 30-year fixed-rate loan at 12%, the average balance outstanding over the entire term is slightly over $70,000. If the average is time weighted, the average balance outstanding is approximately $55,000 over the loan life. Such an adjustment would bring the safe harbor level for points down to either 5.25 or 4.125 respectively. A fixed adjustment factor is relatively simple and yet accommodated most standard mortgage originations.

Accordingly, it would be fairly simple to establish a reasonable adjustment factor of five (5) or six (6) points for the safe harbor calculation which would effectively accommodate standard mortgage transactions. If, however, as the committee report language appears to indicate, the serial obligation rules must be used, the computation becomes extremely intricate and the safe harbor provided very small. In such a case, the OID rules would subject many more loans to exceptionally complex computations without producing any revenue advantage.

DEALING WITH NEGATIVE AMORTIZATION

At the very least, a reasonable safe harbor is necessary since adjustable rate mortgages (ARMs) will further complicate the OID calculation as it applies to the standard mortgage transaction. Currently, a number of ARMs offer lower introductory rates for an initial period after the loan closing. In some instances, the lower payment period extends beyond the period for which the interest accrual rates on the loan is held down. This introduces a minor element of "built-in" negative amortization into the loan. Again, from the theoretical perspective, such negative amortization could be considered original issue discount—since the stated redemption price could be less than the issue price. The built-in negative amortization in certain ARMs is, however, a very minor component in the transaction and should be excluded by an appropriate de minimis rule.

Other types of mortgage loans which are less prevalent but still fairly significant in the marketplace produce much more significant amounts of built-in negative amortization. It is not clear how graduated payment mortgages (GPMs) insured by the Federal Housing Administration should be treated under OID rules, but it is arguable that they, too, fall into that net.

It is our understanding that the Treasury deems it appropriate to make a distinction between the built-in negative amortization referred to above and the contingent deferred interest feature inherent in an ARM which has a monthly payment cap as a borrower protection feature. In many cases, lenders are willing to assume the cash-flow risk of permitting borrowers to defer cash payment of the full interest charge on an ARM when market rates rise. This valuable smoothing of the cash obligation of the borrower may never be triggered if interest rates never rise sharply. Thus such deferred interest, being merely contingent, should never fall into the OID framework since it is not a feature of the loan at origination. If any attempt is made to include such contingent negative amortization into the OID framework, no computer system available to lenders could handle the computation burden since the OID to be included would oscillate with every movement in the loan index.

The application of OID rules to the standard mortgage transaction raises enormous complexities for third party savings institution lenders. For example, the statutory methodology to determine the applicable federal rate (AFR) would have produced completely inappropriate and unintentional results if applied to the adjustable-rate mortgage instrument. ARM loans are priced off the Treasury yield curve at a short term rate to reflect repricing characteristics. Treasury, however, has already been forced to devise an alternate AFR formula because of its own shortcomings even for fixed rate obligations in a volatile interest rate environment.

CASH FLOW UNPREDICTABILITY AND YIELD TO MATURITY

It is also unavoidable reality that the cash flow unpredictability of mortgage instruments fits very poorly into the OID framework which is based on the application of a precomputed yield to maturity to the adjusted issue price (here the outstanding principal balance). The yield to maturity on a home mortgage, where the borrower has a right to prepay at any time (an indeterminate "call" option), is simply impossible to compute in advance. Nor is it acceptable to base the calculations on expected loan life. The average life will not represent any individual transaction and it use will either unduly help or harm an individual borrower. Prepayments can be expected but cannot be guaranteed. Consequently, they should not be used as a rationale for reducing any de minimis safe harbor amount adopted to avoid undue complexities with regard to the tax treatment of points in standard home financing transactions. Adjustable rate mortgages will presumably decrease the frequency of prepayment surges but for these loans it is obvious that yield to maturity is a completely inappropriate concept.

SECONDARY MARKET IMPLICATIONS

Along with ARMs the new market instrument which will suffer adversely from the OID rules is the issuance of multiple-class mortgage securities in collateralized bond form.

Here the problems associated with unpredictable prepayment rates on the mortgage collateral resurface. A basic question is whether anticipated prepayment rates should be used in computing OID recognition for these bonds. As with primary loan originations, we do not feel that any projected prepayments can be used as a reliable or equitable basis for such computations. Difficult adjustment problems would arise if the projected rate did not materialize. Accrual rates might have to be charged even if a particular bond class has not yet been retired but other classes standing ahead of it have been retired earlier than anticipated. Such corporate-issued securities are traded in the open market and have all the issuer and investor characteristics of regular bonds, but inherit the cash-flow unpredictability of the underlying mortgages which fit so poorly into the OID framework.

These problems are exacerbated when relatively low coupon mortgages are used to set up the collateral pool for the pay-through bonds. Here significant amounts of OID are built into the transaction and other tax problems, most noticeably a "phantom income" phenomenon, occurs.

Indeed, all the difficulites outlined above resulting from the application of OID rules to standard mortgages will be compounded in the case of actively traded mortgage securities. Every time a security trades, a segregation will have to be made between original issue and market discount. Separate tracking will be necessary for each type of discount at the same time as computations are being made for the mortgage borrower. Similarly, sales of servicing would be massively complicated by OID considerations. Any recasting of the rules for mortgage finance should always strike an appropriate balance between the occasionally different interests of primary mortgage portfolio lenders and the subsidiary role of non-traditional secondary market investors. But, as major holders of below-market mortgage paper and active participants in the secondary mortgage market, savings institutions are very interested in resolving these OID problems.

ASYMMETRY CONCERNS

The asymmetry introduced into the tax code by the limitation of the borrower deduction to the amount paid in cash under 1275(b)(2) while the lender presumably accures a higher amount including OID into taxable income, is alien to the whole philosophy of OID and is completely indefensible. For negatively-amortizing GPM loans such a rule would be inappropriate. Presumably, however, the amortization of regular points in most standard fixed or variable rate loans might not be affected either because of the appropriate safe harbor we are requesting or because principal is being retired in cash with each monthly payment.

OID PROBLEMS WITH CERTAIN CERTIFICATES OF DEPOSIT

Finally, the question of contingent payments also arises for some of our institutions on the other side of the balance sheet with bonus savings accounts. These bonus accounts require that a significant element of the total interest return should be payable only it the deposit is left undisturbed to maturity. Indexed certificates where a major part of the interest is payable only at maturity face the same problem. These certificates, though relatively small in volume at present, may play a much larger role in our liability structure in the future.

CONCLUSION

Therefore, both the loan and savings operations of our institutions are now faced with information reporting requirements to IRS and our customers. This new mortgage reporting responsibility is enormously complicated by the complex calculations and tracking of OID for borrowers by primary and secondary market lenders. In addition, the many unintended problems outlined in this statement which result from extending OID to regular mortgage transactions makes OID an unwanted and unnecessary burden. We do not believe that Congress intended this OID burden with all its complexity to apply to standard mortgage transactions.

Therefore, with the prospect of substantial mortgage market disruption as a result of OID for negligible revenue gain, the U.S. League recommends to the Ways and Means Committee that all standard mortgage transactions be either exempted from OID or that an adequate safe harbor (5 or 6 points) under 1273(a)(3) be provided legislatively to exempt non-abusive mortgage transactions from costly OID coverage. The U.S. League appreciates the opportunity to share our views with the Committee on this intricate but most important tax issue.

ANALYSIS AND TAX TREATMENT OF ORIGINAL ISSUE DISCOUNT ON MORTGAGES

FACTS ASSUMED FOR OID ILLUSTRATION

The potential impact of original issue discount (OID) on mortgage finance is most clearly illustrated using an example. For the purposes of this discussion, the following facts will be assumed:

(1) Lender originates a mortgage with:
  (A) A Face principal amount of $105,000;
  (B) A Fixed coupon rate of 13%; and
  (C) A 30 year term.
(2) Borrower receives proceeds of $100,000 at closing, as the lender finances points charged to the borrower.

Lender's OID Analysis—Step 1

Will this financing transaction make the mortgage subject to OID rules?

Generally yes, unless:

(A) it is issued by a natural person to the lender before March 2, 1984;
(B) the debt maturity is one year or less at date of issue; or
(C) The debt is between 2 natural person for less than $10,000.

Given these general exceptions, virtually any mortgage will be subject to the OID rules.

In the example:

This financing transaction makes the mortgage subject to the OID rules.

Lender's OID Analysis—Step 2

Determine the amount of OID on the Mortgage:

(A) OID equals "stated redemption price at maturity" in excess of the "issue price".

(B) For a mortgage, OID generally equals the beginning mortgage principal balance and non-periodic interest in excess of proceeds received for the mortgage.

In the example:

Total OID is computed for this mortgage as follows:

Mortgage Principal	$105,000

Mortgage Proceeds	100,000
Total OID	5,000

Lender's OID Analysis—Step 3

Is the OID "De Minimis"?

(A) If OID on the mortgage is computed to be "de minimis", the mortgage is considered to have zero OID.

(B) The De Minimis Rule's Statutory formula is: ¼ of 1% X number of complete years to maturity X stated redemption price at maturity=de minimis OID.

Actual OID is then compared to the de minimis OID computed to determine if the OID rules apply.

(C) Application of Serial Obligation Rules in the regulations to this calculation for a mortgage breaks the mortgage into its component principal payments, i.e., a 30-year amortizing mortgage is treated as being composed of 360 interest bearing balloon payment obligations.

(D) Allocation of OID must be made to each individual mortgage payment.

In this example:

The de minimis calculation requires 2 steps for this mortgage.

Lender's OID Analysis—Step 3A

Allocate OID to each mortgage payment:

(A) As discussed above, this is done based on 360 individual discounted mortgage payments for a 30-year mortgage.

(B) One approach which may be used is to allocated the OID to each individual payments using a constant interest rate.

In the example:

In the absence of regulations stipulating the appropriate methodology for allocating OID, any of several approaches may be used to allocate OID on this mortgage. Total OID of $5,000 would be allocated among all mortgage payments.

Lender's OID Analysis—Step 3B

Compare OID allocated to each payment to De Minimis limit calculated for that particular payment.

(A) This must be done for *each of 360* mortgage payments on a *30 year* mortgage.

(B) Once these comparisons have been completed, the lender must *segregate* payments allocated OID in excess of de minimis limits.

In this example:

Depending on the methodology used, a varying number of the payments may have more than de minimis OID.

Lender's Processing of OID—Step 1

Amortize OID in excess of De Minimis

(A) If not de minimis, the full amount of OID allocated to a particular mortgage payment is amortized using a constant interest method over the term to maturity for the related mortgage payment.

(B) Potentially, 360 separate OID amounts would be amortized over 360 different terms to maturity.

In this example:

A maximum of $5,000 in total OID could potentially be amortized over the 30-year life of this mortgage.

Lender's Processing of OID—Step 2

Annual Informational Reporting

(A) Form 1099–OID generally must be sent to holders of OID mortgages and filed with the IRS for each mortgage.

(B) Borrowers will need to know the amount of annual OID deductions on each OID mortgage to properly compute annual mortgage interest expense. These amounts may have to be reported by lenders to borrowers.

(C) Backup withholding may be required on OID accrued during the year.

Calculations by subsequent holders of the mortgage:

(A) If acquired at a premium, OID income is eliminated for the new holder.

However

(B) If acquired at a discount, annual OID calculations may be adjusted.

(C) Multiple holders during any single year may require the lender to prepare separate forms 1099–OID.

(D) These adjustments have no impact on the original borrower who continues to report annual OID expense deductions.

Potential Variables Further Complicating This Analysis

(A) Application of these rules to an adjustable rate mortgage (ARM) with mortgage cash flows which are uncertain and unpredictable at origination.

(B) Application of these rules to a graduated payment mortgage (GPM) with an initial "teaser" coupon rate. Arguably, interest accruals, in subsequent years in excess of the rate used in the first year would be included in the "stated redemption price at maturity" previously discussed to compute OID on the mortgage.

(C) Ambiguity as to when mortgage points are "financed" versus when such costs are "paid", based on mortgage documentation presently used in the market.

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